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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949

No. 445

BROWN SHOE COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE PETITIONER

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Opinions Below

The opinion of the Tax Court of the United States (R. 23-26) is reported in 10 T.C. 291. The opinion of the Court of Appeals for the Eighth Circuit (R. 149-160) is reported in 175 F. 2d 305.

Jurisdiction

The judgment of the Court of Appeals was entered on June 17, 1949 (R. 161). The petition for rehearing of the petitioner, filed on August 1, 1949 (R. 163-166), was denied on August 8, 1949 (R. 167). The petition for a writ of *certiorari* was filed on November 5, 1949, and granted on

January 9, 1950 (R. 168). The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254.

Questions Presented

1. Whether the amount of $971,031.01, representing the total amount of cash and property other than cash contributed to the petitioner by certain community groups as an inducement to locate a new plant or to enlarge an existing plant in the particular community, is includable in petitioner's equity invested capital, either as a "contribution to capital" under Section 718(a)(1) and (2) of the Internal Revenue Code, or as part of petitioner's "accumulated earnings and profits" under Section 718(a)(4) thereof.

2. Whether the cash in the amount of $885,559.45, or any part thereof, received by the petitioner from the community groups and deposited in its unrestricted bank account, reduces the petitioner's "basis" for depreciation of buildings, machinery and equipment constructed or acquired by the petitioner in the respective communities.

3. Whether the petitioner is entitled to deduct depreciation on the two factory buildings which it received directly from two of the community groups, the said buildings having stipulated bases of $20,251.93 and $65,219.63, respectively.

Statutes and Regulations Involved

The statute and regulations involved are set out in the Appendix, *infra*, pp. 67 to 83.

Statement

This proceeding involves deficiencies in petitioner's excess profits tax for the fiscal years ending October 31, 1942, and October 31, 1943. The facts were stipulated

(R. 27-34), and were found by the Tax Court (R. 23-26). So far as material here, they may be summarized as follows:

The petitioner is a New York corporation, having its principal place of business in St. Louis, Missouri. At all times material here, the petitioner was engaged in the manufacture and sale at wholesale of men's, women's and children's shoes and conducted its manufacturing operations in a number of different plants located in Missouri, Illinois, Indiana, and Tennessee (R. 27-28).

During the years 1914 to 1939, inclusive, the petitioner received $885,559.45 in cash and $85,471.56 (stipulated basis) in buildings from various community groups as an inducement to locate a new plant, or to enlarge an existing plant in the particular community, the total amounting to $971031.01 (R. 24, 28-29)

In one instance involving the payment to petitioner of $10,000.00 cash, there was no contract between the community group and the petitioner. The minutes of the meeting of petitioner's Board of Directors merely state that a "bonus" of $10,000.00 had been paid "as a part of our organization expenses in starting the factory" in Dixon, Illinois (R. 28).

In all of the sixteen other instances, there were contracts between the petitioner and the respective community groups.[1] These contracts varied but generally required the petitioner to construct or acquire a factory, or to enlarge an existing factory in the particular community, operate it for an agreed period of time,[2] meet a specified

[1] Copies of the contracts are attached to the Stipulation marked Exhibits 1-A to 16-P, inclusive (R. 35-109).

[2] Four contracts—namely, those with the Chamber of Commerce and the People of Charleston, Illinois, Exhibit 2-B (R. 39); the Salem Chamber of Commerce, Salem, Illinois, Exhibit 7-G (R. 69); the Chamber of Commerce of Litchfield, Illinois, Exhibit 8-H (R. 71, 73); and the Citizens of Pittsfield, Illinois, Exhibit 13-M (R. 99) did not specify any period of time.

payroll during the agreed period of time and employ a stipulated number of employees (R. 35-107).

In ten instances the amount was to be refunded, or the factory building acquired in the particular community was to be transferred to the particular community group if the petitioner discontinued operations in the particular community prior to the expiration of the specified time.[3]

In six instances the agreements between petitioner and the respective community groups contain no obligation for any repayment of the funds, or transfer of the property.[4]

In all instances the money or property involved was transferred or paid over to the petitioner outright.[5] In five

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[3] Contract with citizens of the city of Charleston, Illinois, Exhibit 1-A (R. 35-37); Contract with citizens of the city of Mattoon, Illinois, Exhibit 4-D (R. 49-51-53); Contract with Chamber of Commerce of Union City, Tennessee, Exhibit 5-E (R. 55-57-59-61-63); Contract with citizens of the city of Salem, Illinois, Exhibit 6-F (R. 65-67); Contract with citizens of the city of Vincennes, Indiana, Exhibit 9-I (R. 75-77); Contract with the Board of Trustees of the Moberly Industrial Foundation for and in behalf of the citizens of Moberly, Missouri, Exhibit 10-J (R. 79-81-83); Contract with the Sullivan Community Club on behalf of the citizens of the city of Sullivan, Illinois, Exhibit 11-K (R. 85-87-89-91-93); Contract with Pittsfield Development Association of Pittsfield, Illinois, Exhibit 12-L (R. 95-97); Contract with citizens of the city of Caruthersville, Missouri, Exhibit 14-N (R. 101-103); and Contract with citizens of the city of Charleston, Missouri, Exhibit 15-O (R. 105-107).

[4] Contract with C. L. Lee, acting for citizens of Charleston, Illinois, Exhibit 2-B (R. 39); Contract with the Mattoon Association of Commerce of Mattoon, Illinois, Exhibit 3-C (R. 41-47); Contract with Salem Chamber of Commerce, Salem, Illinois, Exhibit 7-G (R. 69); Contract with Chamber of Commerce, Litchfield, Illinois, Exhibit 8-H (R. 71-73); Contract with citizens of Pittsfield, Illinois, Exhibit 13-M (R. 99); and Contract with Murphysboro, Illinois, Chamber of Commerce, Exhibit 16-P (R. 108-109).

[5] In this respect the situation is different from that involved in *Frank Holton & Co.*, 10 B.T.A. 1317, decided under the earlier excess profits tax law and relied upon by the Tax Court in the instant case, because in that case title to the property had not passed to the taxpayer and was to be transferred to it only after it had met certain obliga-

instances the contracts contained a clause to the effect that the contributed money was "to be used"[6], and three other contracts contained a clause to the effect that the contributed money was to be "available,"[7] for the payment of a factory building.

The stipulated period provided for in eleven of the contracts,[8] during which the petitioner was to operate the plant, had expired in all but four contracts involving property and cash totaling $190,471.56. (R. 28, 29).

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tions. Such transfer had not taken place on the date which was determinative for the computation of invested capital.

The situation of the petitioner in the instant case is also different from that involved in *C. L. Downey Co.* v. *Commissioner*, 172 F. (2d) 810, relied upon by the Court of Appeals. There, a Chamber of Commerce had advanced money to the company for which the company executed its note with the understanding that the company would be relieved of the necessity of repayment if it complied with certain stipulated obligations concerning the operation of the factory. These obligations had not been met at the critical date. The company contended for the inclusion of the amount in invested capital as "borrowed capital" under Sections 717 and 719 of the Internal Revenue Code, and not as part of its equity invested capital under Section 718, I.R.C.

[6] These five contracts are the contracts with the Charleston Merchants Association, Exhibit 1-A (R. 35); with the Chamber of Commerce of Union City, Exhibit 5-E (R. 57); with the Vincennes Chamber of Commerce, Exhibit 9-I (R. 75); with the Pittsfield Development Association, Exhibit 12-L (R. 95); and with the Charleston Commercial Club, Charleston Junior Chamber of Commerce, Charleston Kiwanis Club and the mayor of the city of Charleston, Exhibit 15-O (R. 105).

[7] These three contracts are the contracts with the Mattoon Association of Commerce and citizens of Mattoon, Exhibit 4-D (R. 51); with the Salem Chamber of Commerce and citizens of Salem, Exhibit 6-F (R. 65); and with the Sullivan Community Club, Exhibit 11-K (R. 87). On the other hand, the contract with the Moberly Industrial Foundation, Exhibit 10-J (R. 79) provides that in consideration of a money contribution of $75,000 the petitioner was to build and operate an addition to its factory, such addition "to be constructed at the expense of said company."

[8] Namely, in the ten contracts identified in footnote 3 on page 4, *infra*, and in the contract with the Murphysboro Chamber of Commerce, Exhibit 16-P (R. 108-9), which contract does not provide for a duty to repay or reconvey.

The petitioner, after it had complied with all of the terms of the respective contracts and the specified period (in those contracts which so provided) had expired, was free to operate the factories in any way it desired, or to dispose of them and retain the proceeds without any obligation to account to the contributing groups (R. 28-30, Exhibits 1-A to 16-P, R. 35-109). The Tax Court assumed, and was correct in so doing, that the petitioner had fulfilled all conditions attached to the transfers (R. 24).

When received from the community groups, the cash was deposited in petitioner's general bank account out of which it paid its general operating expenses, the cost of acquiring other assets and the cost of constructing or acquiring the buildings, machinery and equipment for the factories in the particular communities. The cash received from a particular group "was not earmarked for or held intact and applied against the cost of factory, machinery, equipment, or other items applicable to the plant acquired or constructed in the particular community" (R. 31). The cash payments when received from the community groups were credited to its earned surplus accounts, either directly or after they had first been credited to contributed surplus (R. 30, 31, 113, 114).

The values (stipulated basis) of the two buildings received from the community groups and used in petitioner's trade or business, during the taxable years here involved, were set up in the building account on the asset side of its balance sheet and were credited directly to the surplus account on the liability side (R. 30, 31, 114). The parties have stipulated that the two buildings received by petitioner directly from two of the community groups had "bases" under Section 113(b) of the Internal Revenue Code, for the purpose of computing depreciation and for inclusion in invested capital, in the amounts of $20,251.93 and $65,219.63, respectively (R. 32).

The petitioner found it necessary to train new employees for employment in the new or enlarged factories in the communities from which it received the contributions. The cost of training such new employees was not less than $100 for each new employee. Before the new or enlarged factories could be operated, the petitioner had to supply them with an opening inventory of the materials necessary for the manufacture of shoes. The parties have stipulated the cost of training the new employees, the cost of the opening inventory, the cost of the buildings, cost of machinery, and the cost of land (in instances where land was purchased) for each of the new or enlarged factories in the communities from which it received the contributions (R. 32, 33, 119).

In every instance the cash which the petitioner received from the community groups was less than the amount which it expended for the construction or acquisition of the factory buildings and for machinery and equipment with which to operate the said factories (R. 31). At all times material to the issues in this case, the petitioner had "accumulated earnings and profits" in excess of $971,031.01 (R. 129).

In computing its excess profits net income for the two taxable years here involved, the petitioner deducted depreciation on the two buildings received directly from the community groups and also deducted depreciation on the full cost of the factory buildings, machinery and equipment acquired or enlarged in the communities from which it had received cash contributions. The Commissioner of Internal Revenue disallowed the deduction for depreciation on the two buildings, which the petitioner had received directly from the community groups, and he also disallowed an amount which he determined to be depreciation on the portion of the building, machinery and equipment

which might have been acquired with cash received from the community groups. (R. 13, 16).

The petitioner included the amount of $971,031.01 in its equity invested capital for the two years here involved, but the Commissioner reduced petitioner's equity invested capital by that amount (R. 31-32).

The Tax Court sustained the Commissioner's determination in reducing petitioner's equity invested capital by the amount of $971,031.01 on the ground that the said sum did not constitute part of petitioner's "accumulated earnings or profits", nor part of its invested capital because "the transferors were not stockholders" (R. 24, 25).

The Tax Court also sustained the Commissioner of Internal Revenue in disallowing the deduction of depreciation on the two buildings received directly from the community groups on the ground that "the recipient does not receive a gift and therefore does not take the transferor's basis under section 113(a)(2) on buildings transferred to it as an inducement to locate its business in a particular place." (R. 25) However, the Tax Court held that the Commissioner was not justified in disallowing the deduction for depreciation on a portion of the cost of the buildings, machinery and equipment constructed or acquired by the petitioner in the communities from which it had received cash contributions because "the petitioner paid for the buildings and machinery out of its own unrestricted funds, those buildings and that machinery had cost to it, as shown on its books and records, and it is entitled to depreciation thereon." (R. 26)

On appeal by both parties, the Court of Appeals reversed the Tax Court's finding that the buildings and machinery, constructed or acquired by the petitioner in the communities from which it had received cash contributions, had "cost" to the petitioner in the amounts which it had ex-

pended therefor, and held that the Tax Court's finding was "clearly erroneous" within the meaning of Rule 52(a) of the Federal Rules of Civil Procedure because petitioner's basis for depreciation of the factory buildings and equipment in question is cost and because "cost" means "cost to the taxpayer" and "cost to the taxpayer does not include contributions from others made for business and community interests." (R. 153-154)

The Court of Appeals sustained the Tax Court's determination that petitioner was not entitled to deduct depreciation on the two buildings received directly from two of the community groups, on the ground that under the Statute, 26 U.S.C.A. Section 114, depreciation is allowable "only on the cost to the taxpayer of the property" (R. 160).

The Court of Appeals sustained the Tax Court's determination that petitioner was not entitled to include the amount of $971,031.01 in its equity invested capital as a "contribution to capital" within the meaning of Section 718(a)(1) and (2) of the Internal Revenue Code, because the contributions were not made by shareholders, stating "until the Supreme Court has construed the 1940 Act otherwise, we cannot say that the decision of the Tax Court in this regard is clearly erroneous" (R. 160), and it held that the amount of $971,031.01 was not includable in petitioner's equity invested capital as part of petitioner's "accumulated earnings and profits," because petitioner "did not include any part of that amount in its income tax returns and pay income taxes thereon" (R. 158).

Specification of Errors To Be Urged

The Court below erred:

1. In holding that the amount of $971,031.01, representing cash and property previously received by the peti-

tioner from the community groups, is not includable in petitioner's equity invested capital as money and property paid in as a "contribution to capital" within the meaning of Section 718(a)(1) and (2), I.R.C.

2. In holding that the said amount of $971,031.01 is not includable in petitioner's equity invested capital as part of its "accumulated earnings and profits" within the meaning of Section 718(a)(4), I.R.C.

3. In holding that the petitioner was not entitled to a deduction for depreciation on the two buildings which it had received directly from two community groups.

4. In setting aside as "clearly erroneous" the findings of the Tax Court to the effect that the petitioner had a "cost" basis for depreciation equivalent to the total cost of the buildings constructed by it and machinery and equipment acquired by it in the communities from which it had received cash contributions in the aggregate amount of $885,559.45.

5. In holding that the petitioner's "basis" for depreciation of the buildings constructed by it and the machinery and equipment acquired by it for use in the factories in the communities from which it had received cash contributions, must be reduced by the amount of the cash contributions, as determined by the Commissioner of Internal Revenue.

6. In failing to pass upon petitioner's alternative contention that if the cash contributions received from the various communities are to be treated, for tax purposes, as a payment of a portion of petitioner's cost of starting the factory in the particular community, then the contribution should be allocated not only to the cost of land, buildings, machinery and equipment, but also to the cost of

training new employees and the cost of providing opening inventories with which to operate the factories.

7. In entering judgment for the Commissioner in the two appeals before the Court.

Summary of Argument

I. *The Invested Capital Issues*

The decisions, relied upon by the courts below, under the World War I excess profits tax[9] holding that contributions from nonshareholders are not includable in invested capital, are not in point here because of the different statutory definition of invested capital under the World War II excess profits tax. Invested capital under the earlier law was limited to money or property paid in by shareholders for stock or as paid-in surplus, and earnings accumulated by the taxpayer from past operations.

Under the World War II excess profits tax, the definition of invested capital was broadened to include not only money and property (1) paid in by the shareholders for stock or as paid-in surplus, and (2) earnings accumulated from past operations, but also (3) contributions to capital and (4) borrowed capital which had been explicitly excluded under the earlier law.

The Commissioner's regulations, promulgated under the income tax law (chapter 1 of the Internal Revenue Code), in effect at the time that "a contribution to capital" was adopted as a component of equity invested capital, explicitly provided that "a contribution to capital" may be re-

[9] For convenience, the earlier excess profits tax law (Title II, Revenue Act of 1917, 40 Stat. 300; Title III, Revenue Act of 1918, 40 Stat. 1057; Title III, Revenue Act of 1921, 42 Stat. 227) will be referred to herein as the World War I excess profits tax. The later excess profits tax law (Subchapter E of the Internal Revenue Code) will be referred to as the World War II excess profits tax.

ceived "*from any person.*" The regulations, subsequently promulgated under the invested capital section of the excess profits tax provisions of the Internal Revenue Code (subchapter E) also provided that a contribution to capital may be received "*from any person.*" The Commissioner's insistence in this case that the contributions of money and property in the amount of $971,031.01 are not includable in petitioner's equity invested capital because they were received from nonstockholders, and the lower courts' approval of that argument constitutes, in effect, a repudiation of the Commissioner's regulations on this point.

Contributions of the nature of those here involved have been characterized by this Court, by other courts and by authors of legal, financial and accounting texts as "contributions to capital." Common usage of the term, when Congress first adopted it as part of the income tax law in the Revenue Act of 1932, included contributions of the nature of those here involved.

If this Court should determine that the contributions of money and property other than money in the aggregate amount of $971,031.01 are not includable in petitioner's invested capital as "a contribution to capital," then, as petitioner contends in the alternative, the amount is includable in invested capital as part of its "accumulated earnings and profits" as of the beginning of each of the two taxable years here involved.

The contributions of $971,031.01, being received by petitioner without a corresponding liability, increased the excess of its assets over its liabilities, including capital stock, by a like amount thereby increasing petitioner's surplus as defined by this Court.[10] That surplus was available for distribution to petitioner's stockholders and if distributed

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[10] Petitioner had at all times material to this case accumulated earnings and profits in excess of $971,031.01 (R. 129).

would be taxable to the stockholders as a distribution of "earnings or profits" within the meaning of Section 115 of the Internal Revenue Code.

Since the term "accumulated earnings and profits" as used for excess profits tax purposes is given the same meaning as when used for income tax purposes, it follows that the surplus created by the receipt of the contributions here in question constitutes part of petitioner's "accumulated earnings and profits" as of the beginning of each of the two taxable years here involved and is includable in petitioner's invested capital.

The inclusion of the contributions of $971,031.01 in petitioner's invested capital is consistent with the general scheme of the World War II excess profits tax, which was designed to tax at high rates the excessive earnings of corporations resulting from the rearmament program and the war expenditures. The contributions here involved were received prior to and have no connection with either the rearmament program or the war. They were actively employed as part of petitioner's "working capital" during the years now before this Court, and to exclude them from its invested capital would result in taxing as excessive profits, earnings which are in fact merely a normal return upon petitioner's "working capital."

II. *The Depreciation Issues*

The court below erred in determining that petitioner's basis for depreciation, as otherwise determined, should be reduced by the contributions of cash and property other than cash in the aggregate amount of $971,031.01 on the ground that petitioner is restricted to a "cost" basis for depreciation. Since the amount of $971,031.01 represents "a contribution to capital," petitioner is entitled to the transferor's basis for computing depreciation as provided by Section 113(a)(8)(B) of the Internal Revenue Code.

If this Court should conclude that the contributions in question represent gifts but not a contribution to capital, petitioner would still be entitled to the donor's basis under Section 113(a)(2) of the Internal Revenue Code.

The court below also erred in setting aside as "clearly erroneous" the finding of the Tax Court that the buildings, machinery and equipment in petitioner's factories, located in the communities from which petitioner had received cash contributions, had "cost" to petitioner of the amounts on which petitioner had claimed depreciation. Such finding was fully supported by the record.

The court below also erred in failing to consider petitioner's alternative contention that if the cash contributions were to be used to reduce petitioner's "basis" for depreciation, then such cash contributions should be allocated in part to the cost of training new employees to operate the new or enlarged plants and in part to the cost of providing opening inventories.

ARGUMENT

I. *The Invested Capital Issues.*

(1) The contributions to petitioner in cash and property other than cash in the aggregate amount of $971,031.01 represent "contributions to capital" and are includable in petitioner's equity invested capital under the provisions of Section 718(a)(1) and (2) of the Internal Revenue Code

The uncontradicted facts are that petitioner received from the citizens of various communities during the years 1914 to 1939, inclusive, cash in the amount of $885,559.45 and title to two buildings having a stipulated basis under Section 113(b) of the Internal Revenue Code of $85,471.56, the total amounting to $971,031.01 (R. 24, 28-29). The cash had been paid over to petitioner and the title to the two buildings had been transferred to petitioner prior to

the beginning of the first taxable year here involved (R. 28, 29).

In one instance a payment of $10,000.00 had been made to petitioner without a contract, such payment being designated as a part of its "organization expenses in starting the factory" (R. 28). In all other instances, there were contracts between petitioner and the contributing groups, which varied widely in their terms, but in every instance the contribution was made as an inducement to petitioner to acquire and operate a new factory, or to enlarge and operate an existing factory, in the particular community.

There was no other relationship between petitioner and any of the contributing parties (or the individuals constituting the community groups) except the general relationship created by the contracts; namely, that of a contributor for the welfare of the community on one hand, and an obligation to acquire or enlarge a plant and to operate it in good faith on the other hand. None of the contributors acquired any interest in the plant, any right to employment in the plant, any right to purchase the product manufactured in the plant, or any other right except to see that the plant was operated in the community for the period of time and under the conditions specified in the contract. This fact distinguishes the instant case from the situation in *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 103, where this Court held that a payment made by a customer of a utility company toward the cost of constructing a line to his home or place of business represented "to the customer the price of the service". There, the customer had an enforcible right to the continued service by the utility company after the line had been completed. Here, the contributor acquired no right in the new or enlarged plant, or to its products, except to see that it was operated pursuant to the terms of the contract

for the period of time specified in the contract.[11] After that period had expired, the petitioner was free to operate the plant or to dispose of it and use the proceeds in any way that it might choose (R. 28-30, 35-109).

The plants acquired by petitioner in the communities from which the contributions had been received were being operated by petitioner during the years here involved, although the period during which petitioner was obligated to operate them under certain of the contracts, had expired in all except four instances.[12]

The aggregate amount of $971,031,01, representing the cash and property other than cash received from the communities in question, was reflected in petitioner's surplus account at the beginning of the first taxable year here involved, and was included by petitioner in its equity invested capital for both taxable years (R. 30, 31, 113, 114). The Commissioner reduced petitioner's equity invested capital by that amount.

In computing its excess profits tax for the taxable years here involved, the petitioner used the excess profits credit based on invested capital, because such method produced the lesser amount of tax (Section 712, I.R.C.; Appendix, *infra*, p. 72).

The Tax Court held that the amount of $971,031.01 did not constitute part of petitioner's equity invested capital because "the transferors were not stockholders" (R. 25). This action was upheld by the Court of Appeals on the ground that "until the Supreme Court has construed the 1940 Act otherwise we cannot say that the decision of the Tax Court in this regard is clearly erroneous" (R. 160).

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[11] Four of the contracts did not even specify any required period of operation (p. 3, footnote 2, *supra*).

[12] (R. 95-97; 101-103; 105; 108-109).

(a) The decisions under the World War I excess profits tax relied upon by the courts below are not applicable to this case arising under the World War II excess profits tax because the two acts define "invested capital" different

In reaching the decision that the contributions of cash and property in the aggregate amount of $971,031.01 are not includable in petitioner's equity invested capital as "a contribution to capital" because the contributors were not shareholders, the Tax Court (by following its decision in *McKay Products Corporation*, 9 T. C. 1082) and the Court of Appeals relied upon the decision of this Court in *La Belle Iron Works* v. *United States*, 256 U. S. 377. The Tax Court also cited its own decision in *Liberty Mirror Works*, 3 T.C. 1018, and the decision of the Board of Tax Appeals in *Frank Holton & Co.*, 10 B.T.A. 1317 (R. 24-25, 157, 158).

The decision of this Court in the *La Belle Iron Works* v. *United States*, *supra*, and the decision of the Board of Tax Appeals in *Frank Holton & Co.*, *supra*, were rendered under the World War I excess profits tax. *Liberty Mirror Works*, *supra*, was decided under the World War II excess profits tax, but the conclusion of the Tax Court that a contribution from a nonstockholder is not includable in invested capital was based upon the decision of this Court in *La Belle Iron Works* v. *United States*, *supra*, and the decision in *Frank Holton & Co.*, *supra*.

The above decisions construing the invested capital provisions of the earlier excess profits tax are not applicable to the World War II excess profits tax because of the different composition of invested capital under the two laws. In the earlier law, invested capital was limited to

capital originating with the shareholders; plus earnings accumulated from past operations, while invested capital under the World War II Excess Profits Tax was broadened to include not only capital originating with the shareholders and earnings accumulated from past operations, but also (1) contributions to capital and (2) borrowed capital.

Thus, Section 326 of the Revenue Acts of 1918 and 1921 [13] defines the term "invested capital" to mean:

> "(1) Actual cash bona fide paid in for *stock or shares;*
>
> "(2) Actual cash value of tangible property, other than cash, bona fide paid in for *stock or shares* . . .
>
> "(3) Paid-in or earned surplus and undivided profits . . .
>
> "(4) Intangible property bona fide paid in for *stock or shares* prior to March 3, 1917 . . .
>
> "(5) Intangible property bona fide paid in for *stock or shares* on or after March 3, 1917 . . ." (Emphasis supplied.)

Section 207(a) of the Revenue Act of 1917 (40 Stat. 300) contained substantially the same provisions but the language varied somewhat, because that Act also subjected partnerships to excess profits tax, while the 1918 and 1921 Revenue Acts levied the tax only on corporations.

Borrowed capital was explicitly excluded as a component of invested capital under the earlier law.[14]

It is clear that the earlier law limited invested capital to capital originating with the stockholders with the exception of "earned surplus and undivided profits" which originate with the taxpayer itself. In line with common usage, "paid-in surplus" was defined to mean surplus paid in

[13] 40 Stat. 1057, and 42 Stat. 227, respectively.

[14] Section 207 of the Revenue Act of 1917, 40 Stat. 300; Section 326(b), Revenue Acts of 1918 and 1921, 40 Stat. 1057 and 42 Stat. 227, respectively.

"by a stockholder" and that definition has continued unchanged to the present time.[15]

Therefore, in construing Section 207 of the Revenue Act of 1917 in *La Belle Iron Works* v. *United States, supra,* this Court stated (pages 388-389):

> "Cash paid in, and tangible property paid in other than cash, are confined to such as were contributed *for stock or shares* in the corporation or partnership; and the property is to be taken at its actual cash value 'at the time of such payment,'—distinctly negativing any allowance for appreciation in value . . . .
>
> "The *same controlling thought* is carried into the proviso, which relates to the valuation of patents, copyrights, trademarks, good will, franchises, and similar intangible property. *Every line shows evidence of a legislative purpose to confine the account to such items as were paid in for stock or shares,* and to their values 'at the time of such payment;' * * * *" (Emphasis supplied.)

In *Frank Holton & Company, supra,* also relied upon by the Tax Court, the Board of Tax Appeals held that the taxpayer could not include, in its invested capital for the years 1919 and 1920, the value of a factory building which a community group had promised to transfer to the taxpayer after it had met a specified payroll and had complied with other contractual conditions. The Board based its decision on the ground that the contributors were not stockholders, relying upon the decision of this Court in *La Belle Iron Works* v. *United States, supra.*

When the recent excess profits tax was imposed by the Second Revenue Act of 1940, the principle of limiting invested capital to capital originating with the shareholders,

[15] Article 837 of Regulations 45 (1920 ed.); Regulations 62 (1922 ed.); Treasury Regulations 111, Section 29.113(a)(8)-1 and Treasury Regulations 112, Section 35.718-1, Appendix, *infra*, pp. 76, 78.

plus earnings accumulated from past operation, was abandoned. The definition of invested capital under the new law was broadened to include, not only the capital originating with the shareholders and capital originating with the taxpayer itself from past earnings, but also (1) contributions to capital and (2) borrowed capital, both of which were foreign to the earlier law.

Section 717 of the Internal Revenue Code which, so far as here material, remained unchanged until the excess profits tax was repealed in 1945, defined invested capital as follows:

> "The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719."

Equity invested capital was defined to include among other items the following (Section 718, I.R.C.):

> "(a) DEFINITION.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—
>
> (1) MONEY PAID IN.—Money previously paid in for stock, or as paid-in surplus, *or as a contribution to capital;*
>
> (2) PROPERTY PAID IN.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, *or as a contribution to capital.*" (Emphasis supplied.)

The inclusion of (1) borrowed capital and (2) a contribution to capital in the definition of invested capital under the later Act clearly negatives any "legislative purpose to confine" invested capital "to such items as were paid in for stock and shares", as this Court found to be true with

respect to the earlier law. *La Belle Iron Works* v. *United States*, *supra*.

Both laws sought to recapture a substantial portion of the excessive earnings which were realized as a result of the tremendous expenditures incidental to the two World Wars by taxing, at the high excess profits tax rates, the excess over what was regarded as "normal earnings" of the taxpayer. However, the basic concept of "normal earnings", was different under the two acts.

Under the earlier Act, "normal earnings" were measured by a fair return *on the shareholders' investment in the corporation* and earnings accumulated from past operations.

Under the later Act, "normal earnings" were measured by a fair return on the *working capital of the corporation*. The corporation was given the choice of two methods for determining such fair return; namely, (1) its average earnings during the base period years, 1936 to 1939, inclusive (Section 713, I.R.C.), or (2) a specified return on its invested capital, which, as previously pointed out, included not only capital paid in by the shareholders and accumulated earnings, but also contributions to capital and borrowed capital (Section 714, I.R.C.; Appendix, p. 72 *infra*).

The concept of "normal earnings" under the World War II excess profits tax has been described by this Court as follows (Footnotes omitted.):

> "Under the controlling 1943 law the amount of income subject to this excess profits tax is computed by subtracting from the net income subject to regular income tax the amount of earnings Congress deemed to be a taxpayer's normal and fair return. This deductible amount, called the excess profits credit, was to be computed in one of two ways, whichever resulted in the lesser tax. Sec. 712. The first, not used here, permits a deduction of an amount equal to the com-

pany's average net income for the taxable years 1936 to 1939 inclusive. Sec. 713. The second used here, permits a deduction of an amount equal to 8 per centum of the taxpayer's invested capital for the taxable year. Sec. 714. An includable element of the 'invested capital' is the 'accumulated earnings and profits as of the beginning of such taxable year.' It thus appears that by this method Congress intended, with minor exceptions not here relevant, to impose the excess profits tax on all annual net income in excess of 8% of a corporation's *working capital*, including its accumulated profits." *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 497 (Emphasis supplied.)

Therefore, it is apparent that the decision of this Court in *La Belle Iron Works* v. *Commissioner*, *supra*, and the decision of the Board of Tax Appeals in *Frank Holton & Co.*, *supra*, while correct under the earlier law, are not applicable to the computation of invested capital under the World War II excess profits tax because of the different concept of normal earnings and the different composition of invested capital under the later act. Consequently, the decision of the Tax Court and the decision of the Court of Appeals in this case are incorrect because both are premised upon the decisions under the earlier act and fail to take into consideration the different statutory composition of invested capital under the later act.

(b) The Commissioner's Regulations in effect at the time of the adoption of, and those promulgated by him under, the World War II excess profits tax recognize that a "contribution to capital" may be received from "any person"

The legislative history of the invested capital provisions of the World War II excess profits tax fails to throw any light on the term "contribution to capital" as used in Section 718(a)(1) and (2) of the Internal Revenue Code.

However, Section 728 of the Internal Revenue Code provided that the terms used in that subchapter (Subchapter E) "shall have the same meaning as when used in chapter 1."

Therefore, it is significant that at the time Section 718, I.R.C., was first adopted as part of the Second Revenue Act of 1940, the term "contribution to capital" was in use as part of Section 113(a)(8) of the Internal Revenue Code (a part of chapter 1 of the Code) and had been used in corresponding sections of the prior Revenue Acts continuously since the Revenue Act of 1932 as follows: [16]

"Sec. 113. Adjusted basis for determining gain or loss.

(a) **Basis (Unadjusted) of Property.**—The basis of property shall be the cost of such property; except that—

* * * * * * *

(8) **Property acquired by issuance of stock or as paid-in surplus.**—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus, *or as a contribution to capital*,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law

[16] The legislative history of this provision is discussed herein at, *infra*, pp. 57 to 59.

applicable to the year in which the transfer was made." (Emphasis supplied.)

The term "contribution to capital" was first defined in Income Tax Regulations 86 (Article 113(a)(8)-1), promulgated under Revenue Act of 1934 as follows:

> "In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, *or from any person as a contribution to capital*, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113 (a)(2)." (Emphasis supplied.)

The above provision has been included in all of the subsequent income tax regulations, including the present Regulations 111, as an interpretation of Section 113(a)(8) of the law.[17]

The reenactment of Section 113(a)(8) in the Revenue Acts of 1936 and 1938 and in the Internal Revenue Code, after the term had been defined by Regulations 86, indicates congressional approval of the Commissioner's definition of the term. On well established principles, the regulation is valid. *Brewster* v *Gage*, 280 U.S. 327, 337; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378, and it also has the support of the doctrine that reenactment of the statute without disapproval of regulations there-

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[17] Regulations 94 (Article 113(a)(8)-1), promulgated under the Revenue Act of 1936; Regulations 101 (Article 113(a)(8)-1), promulgated under the Revenue Act of 1938; Regulations 103 (Sec. 19.113(a)(8)-1) and Regulations 111 (Sec. 29.113(a)(8)-1), promulgated under the Internal Revenue Code, the latter Regulations being applicable to all taxable years beginning after December 31, 1941.

under gives them added sanction. *Commissioner* v. *Wheeler*, 324 U.S. 542, 547 (footnote 10).

When the Commissioner promulgated regulations under Section 718 of the Internal Revenue Code, he defined the term "contribution to capital" in the same way in which it had been defined in the regulations promulgated under chapter 1 of the Code. Thus the applicable excess profits tax regulations provide:[18]

> "If the property was acquired after December 31, 1920, by a corporation from a shareholder as a paid-in surplus *or from any person as a contribution to capital*, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made." (Emphasis supplied.)

The Commissioner's Regulations have long provided that paid-in surplus originates with the stockholders.[19] The term "contribution to capital" must, therefore, imply something else or something of a broader meaning so as to include contributions to capital made by stockholders and nonstockholders. This was the view of the Treasury Department at the time that it promulgated its Regulations under Section 718, I.R.C., because, as indicated above, it provided that a contribution to capital may be received from "any person." The term "any person" is plain and not open to doubt, and it is impossible to read into that term such a limitation as to restrict the contributor to stockholders[20] or, as the Commissioner contended be-

[18] Regulations 109, Section 30.718-1; Regulations 112, Section 35.718-1. Appendix, *infra*, p. 78.

[19] Article 837, Regulations 45 (1920 ed.) and Regulations 62 (1922 ed.). Treasury Regulations 111 and 112, which are now in force, so provide in Section 29.113(a)(8)-1 and Section 35.718-1, respectively. (Appendix, *infra*, pp. 76, 78).

[20] Section 3797(a)(1), I.R.C., provides: "When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof— • • • the term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, company or

fore the Court of Appeals in *Commissioner* v. *McKay Products Corporation*, 178 F. 2d 639, 641, "bondholders or holders of some hybrid security."

The provision in the excess profits tax regulations that a "contribution to capital" may be made by "any person" is consistent with the Statute and is a contemporaneous interpretation by the Treasury Department of the excess profits tax provisions and also of the income tax provisions, which must be regarded as having found congressional approval. These regulations are therefore binding, not only on the taxpayers and the Commissioner, but also on the courts and should not be overruled unless for weighty reasons. By holding that contributions to capital can be made only by stockholders, the Tax Court and the Court below have, in effect, invalidated the Treasury regulations and have failed to give any persuasive reasons therefor.

(c) The courts and authors of legal and accounting texts regard contributions of the nature of those here involved as "contributions to capital"

That the amount of $971,031.01 constitutes and was intended to constitute a contribution to petitioner's capital, as distinguished from contributions to its current earnings, seems clear beyond doubt.[21] The money and property when received by the petitioner were set up on the

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corporation." Subparagraph (2) of the same section provides: "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on * * *". It is therefore clear that the contributing community groups or the individuals constituting them are 'persons' within the meaning of the Internal Revenue Code.

[21] If the amount were held to be a contribution to current earnings, it would still be includable in petitioner's equity invested capital under Section 718(a)(4) of the Internal Revenue Code as part of petitioner's accumulated earnings and profits. This point is discussed, *infra*, pp. 36 to 55.

asset side of its balance sheet in the cash account and property account, respectively. There being no corresponding liability incurred by the petitioner in connection with the receipt of the money and property, they obviously increased the excess of its assets over its liabilities, thereby increasing petitioner's capital.

In *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628, 632 (1925), this Court held that certain money and property received by the taxpayer from the Government of Cuba for the construction of a railroad did not constitute taxable income, but represented a contribution to the taxpayer's capital assets, stating (p. 632):

> "The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures • • • All —the physical properties and the money subsidies— were given for the same purposes. It cannot reasonably be held that one was contribution to capital assets, and that the other was profit, gain or income."

The fact that the contributions in the instant case were received from private sources does not distinguish them from the subsidy payments involved in *Edwards* v. *Cuba Railroad Company, supra.*[22] In identifying the character of the payments involved in that case, this Court made no distinction between those received from public sources and those received from private sources, as indicated by the following excerpt from its opinion (p. 632):

> "• • • Such aids, gifts and grants from the government, subordinate political subdivisions, *or private*

[22] This has also been the position of the Treasury Department, whose General Counsel ruled that contributions made by local community groups or chambers of commerce to manufacturing concerns for the purpose of inducing them to locate their plants in the particular community do not result in taxable income, basing this conclusion on *Edwards* v. *Cuba Railroad Co.*, G.C.M. 16952 (Cum. Bull. 1937, 1, p. 134). Appendix, *infra*, pp. 79 to 82.

> *sources*,—whether of land, other property, credit, or money,—in order to induce construction and operation of railroads for the service of the public, are not given as mere gratuities. (citing cases) * * * Usually they are given to promote settlement and to provide for the development of the resources in the territory to be served. The things so sought to be attained in the public interest are numerous and varied. * * *" (Emphasis supplied.)

In *Texas & Pacific Railway Co.* v. *United States*, 286 U.S. 285 (1932), the railroad there involved had received payments from the Government under the Transportation Act of 1920, which provided that all railroads which had been operated by the Government during the war were guaranteed operating revenues for the six months following March 1, 1920, of not less than half the compensation agreed upon in their contracts with the Government during the period of Federal control. This Court held that the payments received pursuant to the guarantee constituted taxable income and contrasted them with contributions to capital of the nature involved in *Edwards* v. *Cuba Railroad Co.*, *supra*, stating (p. 289):

> "The sums received under the Act [Transportation Act of 1920] were not subsidies or gifts,—that is, *contributions to the capital of the railroads,—and this fact distinguishes cases such as Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628. * * * where the payments were conditioned upon construction work performed * * *." (Emphasis supplied.)

These decisions were available to Congress at the time that it first used the term "contribution to capital" in Section 113(a)(8) of the Revenue Act of 1932. Undoubtedly, the term was used in that section in the same sense in which this Court used it in the above-quoted decisions. There can be no doubt that these two decisions were also

well known to the Treasury Department when it issued both its regulations under Section 113(a)(8) of the Revenue Act of 1934 and succeeding revenue acts and the Code (see page 24, *supra*), and also its regulations under Section 718(a)(1) and (2) (see page 25, *supra*).

In *Helvering* v. *Claiborne-Annapolis Ferry Co.*, 93 F. 2d 875 (C.C.A. 4th, 1938), the taxpayer, who operated a ferry across the Chesapeake Bay, received from the State of Maryland annually an amount of $23,000 toward the operation of the ferry. It had other income from the operation of the ferry. One of the questions before the court was whether the amount of $23,000 was income or a contribution to capital. The court held that the amount received by the company from the State of Maryland was clearly income and not a contribution to capital, stating (at p. 876):

> "And it is equally clear that the amount paid by the State was not intended by anyone as a contribution towards or an addition to the capital investment of the taxpayer. Taxpayer's capital was invested in wharves and ferryboats; and the payment by the state was intended, *not to reimburse taxpayer for expenditures it had made in their purchase of equipment*, but to compensate it in part for their operation. As stated above, it was treated in all respects like other income and was available for operating expenses or for the payment of dividends. The case of Edwards v. Cuba Railroad Co., * * * upon which taxpayer chiefly relies, is readily distinguishable. In that case the subsidy payments made by the Cuba government were used to reimburse taxpayer for capital expenditures." (Emphasis supplied.)

In *Lykes Bros. Steamship Co., Inc.*, 42 B.T.A. 1395 (1940), *aff'd.* 126 F. 2d 725 (C.C.A. 5th), the taxpayer contended that certain mail payments received from the Postmaster General for the transportation of ocean mail were exempt to the extent of $250,000, which it was required to hold for

certain special purposes. The Board of Tax Appeals (now the Tax Court of the United States) rejected the taxpayer's contention, stating (at p. 1401):

> "There is little room for doubt that *the entire sums* paid to the petitioner in the taxable years *were subsidies in the sense* that they were governmental aids or grants designed to encourage the expansion of the American Merchant Marine. The huge sums paid in excess of normal postal rates were clearly for that purpose. But, applying the broad term of subsidy to the amounts paid to the petitioner does not solve the question in issue here, because of *the different purposes* for which such governmental grants are made. From the Supreme Court cases a few general rules may be drawn. Governmental grants made in order *to induce construction and operation of railroads are not mere gifts.* Burke v. Southern Pacific R. R. Co., 234 U. S. 669, 679. Such a grant made to a railroad company proportionate to mileage of railway completed is treated as a *reimbursement for capital expenditures and is not income.* Edwards v. Cuba Railroad Co., supra." (Emphasis supplied.)

On appeal, the Court of Appeals for the Fifth Circuit, 126 F. 2d 725, 727, remarked that no part of the payments

> "can be identified as a contribution to capital under *Edwards* v. *Cuba Railroad Co., supra.*"

Authors, who have discussed the nature of contributions similar to those involved in the instant case, have reached the conclusion that they constitute "contributions to capital." Magill, *Taxable Income*, Revised Edition 1945, pp. 387 to 392, discusses the nature of the payments involved in *Edwards* v. *Cuba Railroad Co., supra*, and states (p. 387, 389)

> "Since the subsidy did not come from the stockholders of the railroad * * * *it is a contribution to capital.* There was a net increase in its actual assets which,

it seems, was properly credited to surplus and was available for dividends * * *.

* * * * * * * * *

"They are *all contributions to capital whether* by the Government, by stockholders, or *by third parties*, ouside the bounds of taxable income * * *." (Emphasis supplied.)

He also concludes (pp. 391, 392) that contributions made by chambers of commerce and similar organizations, to induce new industries to settle in their communities constitute capital contributions analogous to those involved in *Edwards* v. *Cuba Railroad Co., supra.*

Harvey, *Some Indicia of Capital Transfers under the Federal Income Tax Laws* (1939) 37 Mich. L. Rev. 745, discusses at length the nature of contributions, such as those involved in the instant case, and expresses the opinion that they represent "contributions to capital." The same conclusion is reached by O'Meara, *Contributions to Capital by Nonshareholders* (1948) 3 Tax Law Review 568.

Authors of financial and accounting texts have reached the same conclusion. Jules I. Bogen in *Financial Handbook*, 3d Ed. (1948) states (p. 808):

"* * * Surplus arises from gifts of assets also in the case of a corporation which receives a donation of a tract of land as an inducement to locate its factory at a designated place. Such gift may be conditioned upon the erection of a factory building, the employment of a stated number of men, etc. After the conditions are fulfilled the surplus arising from the donation may be utilized as the directors dictate, even as the basis for dividend distribution."

Raymond P. Marple, in *Capital Surplus and Corporate Net Worth* (1936), states (pp. 137 and following):

"Donations by stockholders represent contributed capital and, to the extent by which they exceed legal

> capital, should be recorded in capital surplus. * * * Donations by persons who are not stockholders and do not become stockholders by the contribution do not represent investments and must be classified as contributed capital or surplus according to the intents and desires of the person making the contribution. * * * Where the gift [by outsiders] is not intended as permanent capital, but is made available for current use it should be treated as earned surplus. The above is written with a full realization of the fact that donations, even though made available for current dividend purposes, are not 'earnings' in the generally accepted sense of that term. * * * No one is hurt by the declaration of a dividend from a surplus donated for current purposes."

The theory urged by the Commissioner in the Court of Appeals that "the capital of a corporation, as that term is used in the statute, consists only of the capital as defined in its charter and paid in by the stockholders and that there can be no 'contribution to capital' unless a deficit exists therein" (R. 159) is not only at variance with the common usage of the term "contribution to capital" in the legal, financial and accounting sense but also renders the use of that term in Section 718(a)(1) and (2) completely nugatory. If there could be no "contribution to capital" unless a deficit exists in the capital originally paid in by the stockholders, then the use of the term "contribution to capital" as a component of equity invested capital would be meaningless because the corporate taxpayer is expressly given the benefit of the money or property paid in for stock regardless of the time paid in and is not required to reduce that capital by any subsequent impairment. Under certain circumstances the taxpayer is even given the benefit of a deficit in earnings and profits of another corporation, Section 718(a)(7) I.R.C.

There would be no point in defining equity invested capital as money or property paid in for stock or as paid in

surplus "or as a contribution to capital" if the "contribution to capital" were limited to the amount necessary to restore the impairment of the money or property paid in for stock. Obviously, Congress intended the term "contribution to capital" to include something more than money or property paid in for stock or as paid in surplus. The Commissioner's argument on this point was rejected by the Court of Appeals for the Third Circuit in *Commissioner v. The McKay Products Corporation, supra.*

It is clear that contributions from nonstockholders, such as those received by petitioner in the instant case, are "contributions to capital" in the legal, financial and accounting sense and were intended by Congress to be included in equity invested capital.

(d) The inclusion of the amounts here involved in petitioner's equity invested capital as contributions to capital is consistent with the general scheme of the World War II excess profits tax

The intent of Congress to permit the inclusion in equity invested capital of all money and property other than money contributed to the corporation by "any person," as provided in the regulations, seems clear when the World War II excess profits tax is considered as a whole. Two alternative methods of computing the excess profits tax credit are provided, and the petitioner is authorized to use the one which results in the lesser tax. If the petitioner had used the first alternative or average earnings method, the income produced by the contributions of $971,031.01 would have been reflected in its average base period earnings. It is hardly likely that when Congress permitted the petitioner to use the alternative invested capital method of measuring the excess profits tax credit it intended to penalize the petitioner by excluding from its invested capital the amount

of $971,031.01 actually used in the production of its taxable income.

If instead of receiving outright title to the contributions of money and property other than money in the amount of $971,031.01, petitioner had borrowed that amount of money from the contributing groups or from any other source, giving its note therefor, it would have been able to include 50% of that amount in its invested capital as borrowed capital (Section 719, I.R.C.). To exclude the amount of $971,031.01 from petitioner's invested capital because it had acquired full title to the sum from nonstockholders but to include it if petitioner had borrowed the sum from the nonstockholders is incongruous. Had Congress intended such a result, one would expect to find that intention clearly expressed in the Statute. The statutory language not only fails to indicate any such intention, but on the contrary, clearly indicates that Congress intended to include in invested capital "a contribution to capital" from "any person."

This Court concluded in *Commissioner* v. *South Texas Lumber Company, supra*, that Congress intended to include in the excess profits tax credit under the invested capital method a fair return on all of the working capital of the business stating (at p. 497):

> "* * * It thus appears that by this method Congress intended with minor exceptions not here relevant, to impose the excess profits tax on all annual net income in excess of 8% of a corporation's working capital, including its accumulated profits."

The same conclusion as that contended for by the petitioner was reached by the Court of Appeals for the Third Circuit in *Commissioner* v. *McKay Products Corporation, supra*, in which the Court held that a contribution, substantially identical with the contributions here involved,

was includable in the taxpayer's equity invested capital as a contribution to capital under Section 718(a)(1) and (2), I.R.C., stating (p. 642):

> "'Working capital' in common parlance means the value of that with which the enterprise carries on its activity. How much is its stake in the game? What is the amount of money which is in the business? When we find that, we allow that amount to be used as the basis to determine how much the business may earn before becoming subject to excess profits taxes. It seems to us unimportant who makes the contribution to this amount."

All of the contributions here involved, including the two buildings received directly from the community groups, were employed in petitioner's business during the two years here involved, and had been so employed continuously since the dates on which received. They were exposed to all of the risks of the business to the same extent as the petitioner's other capital, and to a far greater extent than borrowed capital, which would, of course, receive preferential treatment in case of insolvency or bankruptcy.

The clear language of the Statute provides that a "contribution to capital" may be included in equity invested capital. The Commissioner's own regulations, in existence at the time that Congress imposed the World War II excess profits tax, provided that a "contribution to capital" may be received from "any person" and his regulations promulgated under Section 718, I.R.C., likewise provided that a "contribution to capital" may be made by "any person." No reason appears why those regulations should be invalidated by restricting the term "any person" to stockholders or some kind of security holders. The contributions here involved are contributions to capital in the legal, financial, and accounting sense, and were intended by Congress to be included in equity invested capital. The decisions of

the Court of Appeals and the Tax Court holding to the contrary on the ground that the contributors were not stockholders are clearly erroneous and should be reversed.

(2) If the contributions in the amount of $971,031.01 are not includable in petitioner's invested capital as a "contribution to capital", then they are includable in its "accumulated earnings and profits" as of the beginning of the taxable years here involved pursuant to Section 718(a)(4), I.R.C.

Petitioner contends, in the alternative, that the contributions of cash and property other than cash in the amount of $971,031.01, which it had received from community groups long prior to the beginning of each of the two taxable years here involved, are includable in its equity invested capital as a part of its "accumulated earnings and profits" pursuant to Section 718(a)(4) of the Internal Revenue Code (Appendix, *infra*, p. 74), which reads in part as follows:[23]

> "(a) Definition.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts reduced as provided in subsection (b)—
>
> * * * * * * *
>
> (4) Earnings and Profits at Beginning of Year.—The accumulated earnings and profits as of the beginning of such taxable year."

This provision was in effect throughout the taxable years here involved. At all times material to this case, the

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[23] This issue was not raised in *Commissioner v. McKay Products Corporation, supra*. It is relevant here only if the Court should conclude that the amount of $971,031.01 was not a "contribution to capital". Petitioner does not contend that the amount should be included in its invested capital twice.

amount of $971,031.01 was actually reflected in petitioner's surplus account on the liability side of its balance sheet. The adjustment made by the respondent, which led to this controversy, was to reduce petitioner's "accumulated earnings and profits" by the amount of $971,031.01, thereby including only the remaining "accumulated earnings and profits" in its equity invested capital.[24]

The Court of Appeals decided this issue against petitioner on the ground that the contributions in the amount of $971,031.01 had not been included in taxable income in the years of receipt, stating (R. 158):

> "This case [*Commissioner* v. *South Texas Lumber Co.*] we think, whatever may be the proper conception of normal earnings under the 1940 Act, settles adversely to the taxpayer the contention that the amount of $971,031.01 representing the money and property received from community groups may be included in its invested capital under Section 718(a)(4) as 'accumulated earnings and profits as of the beginning of such taxable year' for the reason that it did not include any part of that amount in its income tax returns and pay income taxes thereon 'in the years of receipt'. * * *"

The decision of this Court in the *South Texas Lumber Co.* case, *supra*, did not settle the issue presented in the instant case because it involves an entirely different state of facts. The earnings and profits discussion in that case is limited to the specific problems of an installment basis taxpayer. There, the taxpayer, though keeping its books on the accrual basis, reported its income from installment sales on the installment basis under Section 44, I.R.C., under which a taxpayer is permitted to return as taxable in-

[24] At all times material to the issues in this case, petitioner's "accumulated earnings and profits" were in excess of the amount of $971,031.01 (R. 29).

come for a particular year "that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the payment is completed bears to the total contract price". In computing its invested capital, the taxpayer included in its accumulated earnings and profits under Section 718(a)(4), contrary to the Treasury regulations,[25] the amount of "unrealized profit installment sales".

This Court upheld the validity of the regulations under which the unrealized profit installment sales were excluded from the taxpayer's accumulated earnings and profits, stating (p. 506):

> "The regulation is valid. The respondent [taxpayer] can include in its equity invested capital only that portion of its profits from installment payments which it has actually received and on which it has already paid income taxes in the years of receipt."

This Court did not hold, as the court below assumed, that in order to be includable in accumulated earnings and profits, an item must have been subjected to tax in the year of receipt. The regulations, which this Court upheld in the *South Texas Lumber Co.* case, *supra*, explicitly provided that many items which are not subject to tax when received by the corporation are, nevertheless, includable in earnings and profits.

The contributions involved in the instant case do not constitute and were not treated by respondent as taxable income to the petitioner (*G.C.M. 16952*, C.B. 1937-1, p. 133; Appendix, *infra*, pp. 79 to 82) but that does not mean that they are not includable in petitioner's "earnings and profits." The cash had been paid over and title to the two buildings had been transferred to the petitioner before the beginning of the first taxable year here involved, and

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[25] Section 29.115-3, Regulations 111; Appendix, *infra*, pp. 77, 78.

the effect of the receipt of the cash and property other than cash had been reflected in petitioner's "earnings and profits" in the normal manner under established accounting principles. There was no question of deferment of income which would be taxable eventually as in *Commissioner* v. *South Texas Lumber Co., supra.*

Whether the contributions of $971,031.01 constitute part of petitioner's "accumulated earnings and profits" depends not upon whether they were subjected to tax when received by petitioner, as the court below assumed, but, instead, upon whether such amount would be taxable as a dividend in the hands of petitioner's shareholders if distributed.[26]

(a) The term "accumulated earnings and profits", which has the same meaning for both excess profits tax and income tax purposes, is not limited to amounts which have been previously included in taxable income

Section 728 of the Internal Revenue Code provides that the terms used in the excess profits tax subchapter (subchapter E), "shall have the same meaning as when used in chapter 1" (Appendix, *infra*, p. 76), and the regulations promulgated under Section 718(a)(4) (Regulations 112, Section 35.718-2) also prescribe that:

> "* * * In general, the concept of accumulated earnings and profits for the purpose of excess profits tax is the same as for the purpose of the income tax."

That fact was also recognized by this Court in *Commissioner* v. *South Texas Lumber Company, supra*, in which this Court states (at p. 500, footnote 7):

> "The meaning of all terms used in the subchapter dealing with the income tax was expressly made ap-

[26] Assuming that petitioner would have no other surplus available for distribution except that which was created as a result of the receipt of the contributions here involved.

> plicable to terms used in the excess profits subchapter. Section 728, 6 FCA title 26, Section 728. Treasury Regulations 112 provided: '* * *. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax.' Section 35.718-2. See also HR No. 2894, 76th Cong. 3d Sess. 41."

The legislative history of Section 718 indicates that it was the Treasury Department itself which suggested the use of the term "earnings and profits" as a component of equity invested capital in order to take advantage of judicial interpretation which that term had received as a part of the income tax law. The spokesman of the Treasury Department submitted to Congress, at the time that it was considering the Second Revenue Act of 1940, a memorandum entitled "Advantages of the Invested Capital Concept Contained in the Current Excess Profits Tax Proposal over the Invested Capital Concept of the Revenue Act of 1918".[27] The fourth point of that memorandum deals with the concept of earnings and profits, which was subsequently incorporated in Section 718(a)(4) of the Internal Revenue Code, and reads as follows:

> (4) EARNED SURPLUS. The 1918 act provided for the inclusion of earned surplus in invested capital. Much litigation arose concerning the propriety of including various items in determining earned surplus. The current proposal uses the concept of 'earnings and profits' rather than earned surplus. '*Earnings and profits*' *is a term which has been used for many years in the income tax law and which has received lengthy judicial interpretation.* The Bureau records are adequate to reveal the accumulated earnings and profits of corporations." (Emphasis supplied.)

[27] Published in "Joint Hearings before the Committee on Ways and Means, House of Representatives, and Committee on Finance, U. S. Senate," 76th Congress, 3rd Session, page 94.

The use of the term "earnings and profits" in the income tax law, referred to by the Treasury memorandum, is found in Sections 115(a) and (b) of the Internal Revenue Code (Appendix, *infra*, p. 69) and the corresponding sections of prior revenue acts. Section 115(a) defines a taxable "dividend" as follows:

> "(a) Definition of Dividend—The term 'dividend' when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *, without regard to the amount of earnings and profits at the time the distribution was made."[28]

The dividend as defined by Section 115 I.R.C., is includable in the gross income of the recipient under Section 22(a) I.R.C.

Most of the judicial interpretation, referred to by the Treasury spokesman, is found in cases involving questions of whether the distribution of surplus created by the receipt of special types of assets is taxable to the stockholders of the distributing corporation. Those cases turn on the question of whether the surplus created by the receipt of the particular item constitutes "earnings or profits" within the meaning of Sections 115(a) and (b), I.R.C.

Although this Court has frequently dealt with the term "earnings and profits", the cases have always concerned rather narrowly defined aspects of the term. None of them has presented squarely the question as to the extent to which items which are not taxable to the corporation when received are includable in the computation of earn-

[28] The term "earnings and profits" is used interchangeably with the term "earnings or profits". Cf. Sections 115(a) and (b), Revenue Acts of 1928, 1932, 1934, 1936, and 1938, which are published in the Statutes at Large as indicated in the Index, p. VI, *supra*.

ings and profits. Among the questions dealing with earnings and profits which this Court has passed upon, are questions concerning the tax treatment of pre-March 1, 1913 accumulations;[29] distributions in connection with liquidations,[30] and reorganizations;[31] whether a dividend was distributed out of profits of the year 1917 or an earlier year,[32] and whether unrealized profit on installment sales of a taxpayer reporting income on the installment basis is includable in earnings and profits.[33]

The Commissioner's regulations defining "earnings or profits" distinguish between items which are nontaxable and income which is deferred or not recognized. This distinction is readily apparent from the following excerpts from Section 29.115-3 of Regulations 111;[34]

> "* * * a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204-(b)(5) and which is segregated accordingly in the unearned premium reserve.

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[29] *Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347; *Helvering* v. *Canfield*, 291 U. S. 163 and *Foster* v. *United States*, 303 U. S. 118.

[30] *Lynch* v. *Turrish*, 247 U. S. 221; *Commissioner* v. *Wheeler*, 333 U. S. 542.

[31] *Commissioner* v. *Bedford*, 325 U. S. 283; *Commissioner* v. *Fisher*, 327 U. S. 512; *Commissioner* v. *Munter*, 331 U. S. 210 and *Commissioner* v. *Phipps*, 336 U. S. 410.

[32] *Edwards* v. *Douglas*, 269 U. S. 204.

[33] *Commissioner* v. *South Texas Lumber Co.*, *supra*.

[34] The text of this Regulation which is applicable to taxable years beginning after December 31, 1941 and also the text of the corresponding section of the prior regulation is set out more fully in the Appendix, *infra*, pp. 76 to 78.

"Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items deductible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. *Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12).* Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends." (Emphasis supplied.)

The court below apparently failed to note, with regard to the effect on "earnings and profits" the difference between the receipt of items which are not taxable at any time, and deferred installment profits or unearned premium on insurance or nonrecognized gains and losses within the purview of Section 112 of the Internal Revenue Code or corresponding sections of prior revenue acts.

The Commissioner has consistently maintained that practically everything received by a corporation from any source, except money or property paid in by its own stockholders, is includable in its earnings and profits and constitutes a taxable dividend when distributed to its stockholders.

In *Charles F. Ayer*, 12 B.T.A. 284, 287 (1928), the taxpayer had received a dividend out of a depletion reserve based upon discovery value and contended before the Board of Tax Appeals that such depletion reserve did not constitute part of the earnings and profits of the distributing corporation and, consequently, that the dividend was

not taxable to him. The Board of Tax Appeals rejected this argument, stating (p. 287):

> "This is not the only case where some income or profit free from tax in the hands of a corporation is, nevertheless, taxable to a stockholder upon distribution. *Dividends and stock of domestic corporations, interest on bonds and obligations of States and municipalities, and statutory exemptions are not a part of the statutory net income of a corporation, but are nevertheless a part of its earnings or profits and may form a part of ordinary dividends which are taxable when received by the stockholders.* On the other hand, corporations frequently make expenditures which are not deductible from gross income for income-tax purposes, but which nevertheless reduce earnings or profits. It therefore follows that the earnings or profits mentioned in section 201(a) of the Revenue Act of 1921 are not the equivalent of the taxable net income of the corporation. In this connection see *National Grocery Co.*, 1 B.T.A. 688, and *Lynch* v. *Hornby*, 247 U.S. 339." (Emphasis supplied.)

In *Cummings* v. *Commissioner*, 73 F. 2d 477, 480 (C.C.A. 1st, 1934), the corporation there involved had collected more than $200,000.00 under a life insurance policy on the life of one of its executives and, pursuant to an agreement made at the time that the policy was taken out, deposited the amount in a separate bank account and subsequently distributed the sum to its stockholders as a dividend. The proceeds of the life insurance policy were excluded from the gross income of the corporation under Section 22(b)(1) of the applicable revenue act. The stockholders did not report the dividend as taxable income, contending, among other things, that it did not represent a distribution out of earnings and profits of the corporation within the meaning of Section 115(a) of the Revenue Act of 1928 (45 Stat. 791). The Commissioner insisted that the dividend

represented a distribution out of the earnings or profits of the corporation, and his contention was upheld by the Board of Tax Appeals and by the Court of Appeals for the First Circuit. In answering the taxpayers' argument that the distribution was not made out of earnings or profits of the corporation, the Court of Appeals stated (p. 480):

> "'Earnings or profits' as used in this section must mean the same as 'gains or profits' in section 22(a), *and a gift to a corporation would be a gain.* Nor would it be overstating the transaction here to say, that, the company having invested in the insurance policies by paying the premiums, the receipts therefrom over and above the premiums were profits. *If these funds, however derived, belonged to the company when received, they would go to increase its surplus,* and it cannot be seriously argued that the surplus funds in the hands of the company over and above its stock liability are not the earnings or profits contemplated by the section." (Emphasis supplied.)

The same conclusion was reached by the Court of Appeals for the Third Circuit in *Golden* v. *Commissioner of Internal Revenue*, 113 F. 2d 590 (C.C.A. 3rd, 1940). There the corporation, named as beneficiary of certain life insurance policies, had caused the policies to be deposited in a trust company under an arrangement whereby the trust company would collect the proceeds and distribute them directly to the stockholders of the corporation. The obvious purpose of this arrangement was to avoid having the proceeds of the insurance come into the possession of the corporation and thereby increase the assets of the corporation, and also its surplus or accumulated earnings and profits. Nevertheless, the court of appeals held that the proceeds of the insurance when distributed by the trustee directly to the stockholders represented a distribution out of earnings and profits of the corporation, which

was taxable to the stockholders as a dividend. In reaching its decision, the court stated (p. 591):

> "* * * The second, as might be expected, deals with the next step—transference of the insurance proceeds from the corporation-beneficiary to its stockholders. Now the stockholders do not receive those proceeds 'under a contract of insurance'. The contract goes no further than to create a legal relationship between the insurer, the insured officer, and the beneficiary corporation. The amounts received by the stockholders fall rather into the broad category of dividends. They have accordingly been taxed to the stockholders, despite their physical segregation from the corporate assets coupled with a corporate undertaking (by appropriate resolutions passed prior to the insured officer's death) to pay them over to the stockholders when received. * * *"

The proposition that gifts to a corporation are includable in its "earnings and profits" under Section 115 of the Internal Revenue Code and corresponding sections of prior revenue acts as indicated in *Cummings* v. *Commissioner, supra,* was also impliedly approved by Judge Learned Hand in *Rice* v. *Eisner,* 16 F. 2d 358, 360 (C.C.A. 2nd, 1926), where he stated:

> "The exemption in all the statutes of the corpus of gifts and bequests shows that in the minds of those who drew the acts it was thought open to question whether even this might not be considered income."

Judge Ward, in his dissent in *United States* v. *Oregon-Washington R. & Navigation Company,* 251 Fed. 211 (C.C.A. 2nd, 1918), also expressed the same opinion stating (p. 214):

> "The income tax laws of 1913, 1916 and 1917 expressly provide that only the income of gifts is to be taxed, from which it may be inferred, that but for this provision, the gifts themselves would be taxed as income."

In *Annis Van Nays Schaeppe* v. *Commissioner*, 8 T.C. 1224, *aff'd. per curiam*, 168 F. 2d 284, the Tax Court determined that an increase in the surplus of a corporation which resulted from the successful pleading of the statute of limitations against a creditor constituted earnings and profits within the meaning of Section 115(a) of the Internal Revenue Code, stating (p. 1232):

> "* * * By virtue of the judgment of the California court, the amount of $400,000 was released to the general uses of the building company and its assets, previously offset by the obligation of the note, were made available to the building company. This benefit, we think, is 'earnings and profits' within the meaning of section 115(a). * * *"

The administrative practice has gone so far as to include in "earnings and profits", for the purpose of making up a deficit, gifts made to the corporation by its principal stockholder, which, for excess profits tax purposes, would be classified as paid-in surplus. This is indicated in a ruling published in 1924 which has never been revoked.[35] The official headnote of that ruling reads as follows:

> "Bonds of the M Corporation and interest thereon were contributed to the corporation as gifts by its principal stockholders, the amounts thereof being credited to its surplus account. These contributions were sufficient to wipe out a deficit sustained prior to 1916 and at the time of a dividend payment in 1918 its earnings were in excess of the amount of the dividend and the books reflected a surplus in excess of the amount of the dividend.
>
> "There being no evidence that even a partial liquidation of the assets was contemplated or attempted, the legal presumption that the dividend was paid from surplus profits would apply. It is held that the div-

[35] I.T. 1924, Cumulative Bulletin III-1, p. 27. Cf. *Commissioner* v. *Rosenbloom Finance Corporation*, 66 F. 2d 558 (C. C. A. 3rd, 1933).

idend was a legal dividend and not a return of capital even though the contributions were allowed for excess profits tax purposes as paid-in surplus and its invested capital consequently was not decreased by the operating deficit."

In *Commissioner* v. *F. J. Young Corporation, et al.*, 103 F. 2d 137 (affg. 35 B.T.A. 860), the Court of Appeals for the Third Circuit held that a gain to a corporation, although not recognized under Section 112(b)(5), was, nevertheless, includable in its earnings and profits under Section 115(a) despite the provision to the contrary in the Commissioner's regulations. In order to give legislative sanction to that portion of the regulations which had been overruled by that case,[36] Congress adopted, as Section 501 of the Second Revenue Act of 1940, Sections 115(l) and (m) of the Internal Revenue Code containing a partial definition of earnings and profits. This definition relates principally to the non-recognition provisions of Section 112 and increase in value accrued before March 1, 1913. None of those provisions is relevant here. That partial definition of earnings and profits does not deal with the treatment of items, such as the contributions involved in this case, which are not taxable when received by the corporation.

In *Commissioner* v. *Wheeler, supra*, this Court held that the Commissioner's regulations under Section 115, which prohibited the inclusion in earnings and profits of gains or losses which have not been recognized under Section 112, were valid in the form in which they existed before the adoption of the 1940 Amendment, stating (p. 545):

"Although the term 'earnings and profits' has long been in the revenue acts, in connection with the definition of dividend it has never been defined by the

[36] H.R. Rep. No. 2894, 76th Congress, 3rd Session (C.B. 1940-2, pp. 496, 526). The text of Section 115(l) and (m) is set out in the Appendix, *infra*, pp. 70, 71.

statutes (except in so far as § 501 (a) of the Second Act of 1940 has now done so). But under the Revenue Act of 1934 and succeeding acts, the Commissioner dealt by regulation with that portion of the problem of definition relevant here. Article 115-3 of Treasury Regulations 101, promulgated under the 1938 Act, provided in part as follows: 'Gains and losses within the purview of Section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.' This regulation, if valid, disposes of the controversy, for when the corporation sold its securities acquired from the Wheelers it realized gain, based on transferor's cost, which was fully recognized under § 112."

* * * * * * *

(p. 547)

"We therefore think that on principles often reiterated the regulation is valid and decisive of this issue. There is no necessity to predicate the determination of deficiency on the 1940 amendment. * * *" (Footnotes omitted.)

The Commissioner's regulations and the cases holding that items which are not taxable to the corporation when received, nevertheless, enter into the computation of its "earnings and profits", still stand. The decision of the court below, by excluding from "earnings and profits" items which are not taxable to the corporation when received, in effect, overrules that portion of the regulations and immunizes the surplus created by the receipt of such items when distributed to stockholders of a corporation as a dividend. This, we submit, was not the holding of this Court in *Commissioner* v. *South Texas Lumber Co., supra.* Therefore, it is clear that the Court of Appeals erred in holding that the contributions of $971,031.01 are not in-

cludable in petitioner's "accumulated earnings and profits" because they had not been previously included in petitioner's taxable income.

(b) The surplus created by the receipt of the contributions in the amount of $971,031.01 was available for and could be distributed as dividends by petitioner

There can be no question that the receipt of the cash and property other than cash in the aggregate amount of $971,031.01 increased petitioner's surplus by a corresponding amount. Petitioner received outright title to the two buildings and included them in its building account on the asset side of its balance sheet. It also received outright the cash and included that cash in its general cash account on the asset side of its balance sheet. The total increased its assets over its liabilities, including capital stock, by the amount of $971,031.01. That excess of assets over liabilities represented surplus or undivided profits as indicated by this Court in *Willcuts* v. *Milton Dairy Co.*, 275 U.S. 215, in which it stated (at p. 218):

> "* * * Both these terms [surplus and undivided profits] as commonly employed in corporate accounting denote an excess in the aggregate value of all the assets of a corporation over the sum of all its liabilities, including capital stock."

The authors of accounting and financial texts agree that the surplus created by the receipt of contributions of the nature of those involved here is available for distribution as a dividend after the conditions prescribed in the contracts have been fulfilled (*supra*, pp. 31, 32). Here, all conditions prescribed in the contracts with the contributing groups had been completely fulfilled with the exception of four instances.[37] However, in those four instances, too,

[37] R. 95-97; 101-103; 105; 108-109.

petitioner held clear title to the money and property subject only to the condition that the new or enlarged plant be operated in good faith for the specified period of time. Under well established principles, the increment resulting from the receipt of the money and property in those four instances belonged to petitioner."

Under the law of the State of New York, the State in which the petitioner is incorporated, the petitioner would have been free to distribute its entire surplus, including the surplus created by the receipt of the amount of $971,031.01, if its board of directors had decided to make such a distribution. This follows from Section 58 of the Stock Corporation Law of the State of New York.[39] Under that provision, a corporation is merely prohibited from declaring and paying dividends which impair its capital and which do not leave assets at least equalling the aggregate amount of all liabilities including the capital. Cf. *Randell*

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[38] For example, in *North American Oil Consolidated* v. *Burnet*, 286, U. S. 417, this Court stated (p. 424):

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

In *Commissioner* v. *Wilcox*, 327 U. S. 404, 408, this Court stated:

> "• • • a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain, and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain."

If this Court should conclude that the increment resulting from the receipt of the money and property in the four instances in which the condition subsequent had not been fulfilled, at the beginning of the first taxable year here involved, is not includable in petitioner's "earnings and profits", that conclusion would not justify the exclusion of the entire amount of $971,031.01 as the Court of Appeals did. *Helvering* v. *Taylor*, 293 U. S. 507, 515, 516.

[39] As amended in 1938 and 1939, c. 59 of the Consolidated Laws of New York (Appendix, *infra*, p. 831).

v. *Bailey*, 23 N.Y.S. (2d) 173, *aff'd.* 288 N.Y. 280, 43 N.E. (2d) 43 (1942).

It is true that this Court stated in *Edwards* v. *Cuba Railroad Company*, *supra*, that the contract with the Republic of Cuba did not "indicate that the money subsidies were to be used for the payment of dividend, interest or anything else properly chargeable to and payable out of earnings and income". However, it appears that this statement pertained to the analysis of the nature of the subsidies; namely, whether they were contributions to income (and taxable as income), or contributions to capital (and not taxable as income). The distinction between the two types of subsidies was clearly indicated by this Court in *Texas & Pacific R. R. Co.*, v. *United States*, *supra*, and extensively discussed by the Board of Tax Appeals in *Lykes Bros. Steamship Co., Inc.*, *supra*.

In *Burke* v. *Southern Pacific Railroad Co.*, 234 U.S. 669, 680, this Court characterized the grants or subsidies to the railroad there involved as having been "earned" after the company had complied with the terms of the act granting the subsidies, stating (at p. 680):

> "* * * And when, by constructing the road and putting it in operation, the company performed its part of the contract, it became entitled to performance by the government. In other words, it earned the right to the lands described. * * *"

See also *Louisville & Nashville R. R. Co.* v. *United States*, 267 U.S. 395, 402.

Petitioner did not obligate itself not to use the surplus created by the receipt of the contributions here involved for the distribution of dividends. The receipt of such contributions increased petitioner's surplus. That surplus was available for dividend distribution.

(c) Since any distribution of the surplus created by the receipt of the contributions in the amount of $971,031.01 would constitute a taxable dividend to petitioner's stockholders, the amount is part of petitioner's "earnings and profits" and is includable in its invested capital

While there is no decision directly holding that the distribution of surplus, created by the receipt of contributions of the nature of those involved here, is taxable to the stockholders of the distributing corporation, nevertheless it seems clear that the Commissioner would tax such a distribution to the stockholders. The whole tenor of his regulations under Section 115, the administrative practice as reflected in I. T. 1924, *supra*, and the principles laid down by this and other Courts indicate that surplus created by the receipt of tangible items having real value, such as the money and property involved here, may not be distributed to the stockholders free of tax[40] merely because such items were not subjected to tax when received by the corporation.

The applicable principle has been summarized by this Court in *Commissioner* v. *Phipps*, 336 U.S. 410, where, in discussing the Sansome Rule, this Court stated:

> "* * * The Sansome rule itself, as applied to earnings and profits, has never been thought to be controlled by ordinary corporate accounting concepts; its uniform effect is to treat for tax purposes *as earnings or profits* assets which are properly considered *capital* for many if not most corporate purposes, and it has long been a commonplace of tax law that similar divergences often occur. (Citing cases.)
>
> "Congress has expressed its purpose to tax all stockholders who receive distributions of earnings and profits. * * *" (Emphasis supplied.)

The contributions here involved are comparable to the insurance proceeds involved in *Cummings* v. *Commissioner*, *supra*, and *Golden* v. *Commissioner*, *supra*. Both are tan-

[40] And applied to the reduction of the basis of the stock only.

gible items of unquestioned value which increased the assets of the receiving corporation and thereby increased its surplus. The fact that the insurance proceeds were not subject to tax in the hands of the two corporations, did not immunize in the hands of the stockholders the distribution of the surplus created by the receipt of such proceeds. The same reasoning would apply here. Any distribution of the surplus created by the receipt of the contributions in the amount of $971,031.01 would be taxed to petitioner's stockholders as a dividend.

In order to sustain such a tax, the Commissioner would have to determine that the amount of $971,031.01 was includable in petitioner's "earnings and profits" under Section 115 of the Internal Revenue Code. If the contributions are includable in petitioner's "earnings and profits" under Section 115 of the Internal Revenue Code, they are also includable in petitioner's invested capital as part of its "accumulated earnings and profits" under Section 718 (a)(4) of the Internal Revenue Code.

When introduced in 1940, the excess profits tax was intended to prevent any undue enrichment under the rearmament program.[41] The contributions here involved have no reference to the rearmament program. They were received prior to, and most of them many years prior to, the year 1940, the first year for which the excess profits tax was levied. If the contributions in question are not included in petitioner's equity invested capital, either as contributions to its capital or as a part of its accumulated earnings and profits, the income which was earned by the employment of those contributions will be taxed as excess profits, although, in fact, such income is merely the normal

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[41] See the outline of the legislative history of the 1940 law, with references to the message of the President and statements made in Congressional reports, in 7A Mertens, *Law of Federal Income Taxation* (1943), pp. 19 to 25.

return on "working capital" actually employed in the business.[42]

Therefore, the decision of the court below on the invested capital issue was wrong and should be reversed.

II. The Depreciation Issues

(1) The contributions of cash and property other than cash in the aggregate amount of $971,031.01 should not be eliminated from petitioner's "basis" for depreciation because petitioner is entitled to the "substituted basis" provided by Section 113, I.R.C.

The petitioner took deductions for depreciation on the two buildings which it received from the community groups and on its full cost of the buildings and machinery in the factories located in the communities from which it had received cash contributions. These deductions were allowed by the Commissioner until the beginning of the first of the two taxable years here involved. For the two years here involved, the Commissioner disallowed depreciation on the two factory buildings and he also disallowed a portion of the depreciation deducted by the petitioner on the factories located in the communities from which petitioner had received cash contributions, representing what he considered to be the depreciation on that part of the buildings and machinery which might have been acquired with the contributed cash (R. 31, 32, 115).

The Tax Court sustained the Commissioner's disallowance of depreciation on the two buildings received directly from two of the community groups (R. 25), but found that the buildings and machinery in the new or enlarged factories in the communities from which petitioner had received cash contributions had "cost" to petitioner, and

[42] See Montgomery's *Federal Taxes on Corporations* (1945-1946), Vol. 2, p. 383.

that the Commissioner was not justified in reducing that "cost" for the purpose of computing depreciation (R. 25, 26).

The court of appeals reversed the Tax Court's finding that the buildings and machinery in the factories located in the communities from which petitioner had received cash contributions had "cost" to the petitioner as "clearly erroneous" under Rule 52(a) of the Federal Rules of Civil Procedure on the ground that "cost means cost to the taxpayer" (R. 153). It sustained the Tax Court's decision that petitioner was not entitled to depreciation on the two buildings received directly from the two community groups on the ground that "under the Statute, 26 U.S.C.A. Section 114, depreciation is allowable only on the cost to the taxpayer of the property" (R. 160).

At all times material to the issues in this case, Section 23(l)[43] of the Internal Revenue Code has provided for a reasonable allowance for depreciation on property used in the taxpayer's trade or business. Section 23(n), I.R.C., provides that the basis upon which the depreciation is to be allowed shall be as provided in Section 114, I.R.C. The latter section provides that the basis for depreciation shall be the adjusted basis of Section 113(b) for the purpose of computing the gain upon the sale or other disposition of the property. Section 113(b) provides that the adjusted basis for determining the gain or loss from the sale or other disposition of the property "shall be the basis determined under subsection (a), adjusted as hereinafter provided."

Thus, the petitioner's right to deduct depreciation on the properties here in controversy depends upon Section 113(a), which provides that "the basis of property shall be the cost of such property; *except that* —

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[43] The text of this and the other sections of the Internal Revenue Code referred to here will be found in the appendix, *infra*, pp. 67 to 69.

"(2) * * * If the property was acquired *by gift after December 31, 1920*, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, * * *

"(8) * * * If the property was acquired after December 31, 1920, by a corporation—

(B) as paid-in surplus or *as a contribution to capital*,

then the basis shall be the same as it would be in the hands of the transferor, * * * " (Emphasis supplied.)

If this Court concludes that the contributions of cash and property in the aggregate amount of $971,031.01 were received by petitioner as a contribution to capital, as urged by petitioner (pp. 14 to 36, *supra*), it follows that petitioner is entitled to use the transferor's basis for the purpose of computing depreciation. That basis has been stipulated for the two buildings (R. 32). The cash is itself the measure of the transferor's basis for the cash contributions.

If this Court should conclude that the contributions in question represent gifts but not contributions to capital within the meaning of Section 113(a)(8), then the petitioner is still entitled to the transferor's basis under Section 113(a)(2), I.R.C.

The legislative history of the "substituted basis"[44] provisions of Sections 113(a)(2) and 113(a)(8) indicates that those provisions were intended to prevent the donee or transferee from using a "stepped-up basis," as the courts had held that he could do prior to the amendment of the

[44] The term is defined in Section 113(b)(2), I.R.C., Appendix, *infra*, p. 68.

law.[45] The requirement that the donee must use the donor's basis in the case of gifts was first adopted as Section 202(a)(2) of the Revenue Act of 1921, 42 Stat. 227, and has been continued since that time. The Commissioner's regulations applied that provision to property paid-in to a corporation as paid-in surplus. However, in *Rosenbloom Finance Corporation*, 24 B.T.A. 763, the Board of Tax Appeals held that property contributed to a corporation by the majority stockholder and taken up on the books of the corporation as paid-in surplus was not a gift within the meaning of Section 204(a)(2) of the Revenue Act of 1924, which corresponds to Section 202(a) of the 1921 Act, and that the receiving corporation was not restricted to the transferor's basis.

On appeal, the Court of Appeals for the Third Circuit held that such a transfer by the majority stockholder to the corporation was a gift and that the corporation was limited to the transferor's basis for the purpose of computing gain or loss upon the sale of the property.[46] However, the decision of the Board of Tax Appeals in the *Rosenbloom Finance Corporation* case, *supra*, led to the adoption of Section 113(a)(8) of the Revenue Act of 1932, which has been continued in each of the succeeding revenue acts and is the same as Section 113(a)(8) of the Internal Revenue Code.[47]

There is no suggestion in the legislative history nor in any of the court decisions which preceded the adoption of

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[45] 3 Mertens, *Law of Federal Income Taxation*, Section 21.105, footnote 8 sets out provisions of the Committee reports which led to the substituted basis provisions incorporated in Section 113(a)(8), and Section 21.39 sets out the reasons which led to the substituted basis provisions of Section 113(a)(2).

[46] 66 F. 2d 556 (1933); *cert. den.* 290 U.S. 692.

[47] H.R. Rep. No. 708, 72nd Cong., 1st Sess., p. 21; Senate Rep. No. 665, 72nd Cong., 1st Sess., pp. 27-28; H.R. Rep. No. 1492, 72nd Cong., 1st Sess., p. 13.

the "substituted basis" provisions of Sections 113(a)(2) and 113(a)(8) that the donee or transferee is not entitled to any basis for a computation of gain or loss, or for the computation of depreciation, on property received as a gift or as a contribution to capital. The sole concern was to limit the donee's basis to the basis in the hands of the donor or transferor.

Prior to the decision of this Court in *Detroit Edison Company* v. *Commissioner*, *supra*, the administrative practice of the Bureau was to allow depreciation on such property including property received as a contribution under circumstances similar to those involved here. In *Frank Holton Co.*, *supra*, the Board of Tax Appeals noted that the Commissioner had allowed depreciation on the building there involved for the period of time after title had been transferred to the taxpayer. Here depreciation was allowed on the two contributed buildings and on the other property up to the beginning of the first of the two taxable years now before the Court.

The Commissioner now takes the position that, in effect, the decision of this Court in the *Detroit Edison Company* case abrogated the "substituted basis" provisions of Section 113(a), I.R.C. Petitioner submits that this Court did not make any such sweeping determination in that case. There, this Court determined that amounts paid by the consumers to the utility company were neither gifts nor contributions to capital, stating that (p. 102):

> "It overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company * * *"

This Court found that the "payments were to the customers the price of the service" and that, consequently,

the utility company was not entitled to the substituted basis provisions of Sections 113(a)(2) or (8).

Here, it does not overtax imagination to regard either the community groups or the individual contributors comprising those groups as makers of either donations or contributions to the petitioner. No individual contributor or community group was buying anything from the petitioner. The contributions were made voluntarily. The makers intended to transfer to petitioner an economic benefit or gain, and the petitioner was to have and retain title to it.

We submit that the decision of this Court in the *Detroit Edison Company* case has no more application to gifts coming under Section 113(a)(2), or contributions to capital coming under Section 113(a)(8) than it has to devises coming under Section 113(a)(5). In rejecting an argument of the Commissioner that the devisee was not entitled to depreciation on inherited property because such property had no "cost," the Tax Court stated in *Charles B. Currier et ux* v. *Commissioner*, 7 T.C. 980, 984:

> "The basis of inherited property is accordingly not cost, as it was in the *Detroit Edison* and *Reisinger* cases, and to say that a property cost the taxpayer nothing makes no contribution to the solution of the present question. As opposed to cost, the basis of property acquired by devise is categorically fixed by statute as fair market value on the date of acquisition. Internal Revenue Code, Section 113(a)(5)."

The argument that the decision of this Court in the *Detroit Edison Company* case has limited the basis of depreciation to "cost to the taxpayer" was advanced on behalf of the Commissioner in *Commissioner* v. *McKay Products Corporation*, *supra*, just as it was in the instant case, but was rejected by that Court for the reasons submitted by the petitioner here. The reasoning of the Court on this point

in the *McKay Products Corporation* case is as follows (p. 643):

> "Detroit Edison Co. v. Commissioner, 319 U.S. 98 (1943) was relied upon by the Tax Court for its conclusion. If it is in point it controls. But we think it is not our case. In the Detroit Edison case, the taxpayer charged consumers for the cost of extending electric current distribution facilities and claimed as a base for computing its depreciation the full cost of the installations. The Court held that funds so paid by consumers to the taxpayer utility were neither gifts nor contributions to capital. "It is enough to say that it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company. * * * The payments were to the customer the *price of the service.* [Emphasis added.] 319 U. S. at 102-103.
>
> "We think that what is significant is that the Detroit Edison Co. was in the business of selling electric power to the very persons whose payments it sought to depreciate, and that it was Detroit Edison's policy to deliver power to outlying areas only if the consumer bore the cost of the line extension. The matter is really summed up in the Court's statement that payments were part of the price of the service."
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> * * * * *
>
> "* * * Looking as they do toward business continuity, the Internal Revenue Code's depreciation provisions—and especially those which provide for a substituted rather than a cost basis—would seem to envision allowance of a depreciation deduction in situations like this. We think that this transfer entitled the taxpayer to its donor's basis under Section 113(a)(2), and furthermore, for the reasons given in the discussion above of the excess profits tax problem, that the same conclusion follows under Section 113(a)(8) * * * "

Petitioner submits that the reasoning of the Court set forth above is correct and is applicable to the contributions

of money and property here involved. The contributions here involved were made by individuals and groups who knew what they were doing; who intended to convey full and complete title to petitioner; who intended that petitioner should enjoy the economic benefit so conveyed and who were not purchasing any service or right other than the intangible satisfaction derived from the improvement in the general welfare of the community. The same kind of satisfaction is derived by every contributor to a community chest or educational institution designed to improve the general welfare of the community. Congress intended and specifically provided that the donee or transferee of such a contribution should have the "substituted basis" provided in Section 113(a) of the Internal Revenue Code. The decision of the court below holding to the contrary is clearly wrong and should be reversed.

(2) The court below was not justified in setting aside as "clearly erroneous" the finding of the Tax Court that the buildings and machinery were paid out of petitioner's own unrestricted funds and that such buildings and machinery had a "cost" basis to petitioner.

The Tax Court refused to approve the Commissioner's disallowance of a portion of petitioner's depreciation on the factories located in the communities from which petitioner had received cash contributions, stating (R. 25-26):

> . . . However, no justification appears for the action of the Commissioner in disallowing depreciation on buildings, machinery and equipment upon the theory that the petitioner used cash received from the various communities to pay for those buildings and that machinery, and, consequently, the buildings and machinery had, to that extent, no cost to the petitioner. The parties have stipulated that the cash was not earmarked in any way and it is just as reasonable to as-

sume that it was used for any one of a dozen other purposes as it is to make the Commissioner's assumption. The petitioner paid for the buildings and machinery out of its own unrestricted funds, those buildings and that machinery had cost to it, as shown on its books and records, and it is entitled to depreciation thereon."

The court below set aside this finding as "clearly erroneous" under Rule 52(a) of the Federal Rules of Civil Procedure, stating that (R. 154):

> "the Tax Court committed a clear mistake of law and fact when it concluded that the application of the donated funds to the cost of the factories and machinery depended upon the taxpayer's accounting system, . . ."

The petitioner submits that Judge Murdock, who heard the case in the Tax Court, did not commit a clear mistake of law and fact. The stipulation of the parties, including the exhibits attached thereto, clearly support Judge Murdock's finding. It is significant that the same judge made a finding to the contrary in the case of *C. L. Downey Co.*, 10 T.C. 837, *aff'd.* 172 F. 2d 810, which involved a transaction of the same general nature as in the instant case. His observation that the contributed cash might have been used for any one of a dozen other purposes is supported by the observation of this Court in *Edwards* v. *Cuba R.R. Co.*, *supra*, where, in referring to the purpose for which public and private subsidies had been given to railroads in this country, this Court stated (p. 632):

> "Usually they are given to promote settlement and to provide for the development of the resources in the territory to be served. The things so sought to be attained in the public interest are numerous and varied."

The same statement is applicable to the cash contributions here involved. In holding that such contributions were not given solely for the acquisition of buildings and machinery, Judge Murdock is fully supported by the record which shows that petitioner found it necessary to train new employees for employment in the new or enlarged factories at a cost of not less than $100 for each employee, and also found it necessary to provide opening inventories with which to operate the factories (R. 32-33; 119). Even in those instances where the contracts provided that the cash contribution was to be used for buildings and equipment, the petitioner had to provide many other things, such as insurance on the plant, opening inventories with which to operate the plant and it also had to train new employees. Obviously the Tax Court had these other obligations in mind when it made the finding objected to by the court below.

The petitioner submits that the following statement in a recent decision of this Court [48] is applicable to the situation in the instant case:

> "* * * While, of course, it would be our duty to correct clear error, even in findings of fact, the Government has failed to establish any greater grievance here than it might have in any case where the evidence would support a conclusion either way but where the trial court has decided to weigh more heavily for the defendants. Such a choice between two permissible views of the weight of evidence is not 'clearly erroneous'."

The fact that the Tax Court has decided to weigh more heavily for petitioner on this point in choosing between two permissible views of the weight of the evidence does not make its finding "clearly erroneous". The findings of the Tax Court on this point should be reinstated, if this Court

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[48] United States v. Yellow Cab Company, — U.S. — (December 5, 1949).

should not accept the petitioner's principal contention that the contributions of cash and property represented contributions to capital or gifts entitling the petitioner to the basis of the donor or transferor for the purpose of computing depreciation.

(3) **If the cash contributions are to be used to reduce petitioner's basis for depreciation, such contributions should be allocated not only to the cost of land, buildings and machinery but also to the cost of training new employees and the cost of providing opening inventory with which to operate the new or enlarged factories.**

All of the contracts between petitioner and the contributing groups contemplated the operation of the new or enlarged factory in the particular community and the employment of local employees and not merely the construction or acquisition of the particular factory and machinery. The parties stipulated before the Tax Court that petitioner found it necessary to train new employees for employment in the new or enlarged factories, and also found it necessary to supply the new or enlarged factories with opening inventory. The cost of training the new employees and the cost of the opening inventories were also stipulated (R. 32, 33, 119).

Petitioner contended, in the alternative, before the Tax Court, before the Court of Appeals and is so contending before this Court that if the cash contributions are to be allocated to buildings and machinery for the purpose of reducing petitioner's basis for depreciation, as the Commissioner has done, then such cash contributions should be allocated, not only to the building, machinery, and land (in instances where land was acquired) but also to the cost of training new employees and the cost of providing the opening inventories necessary to operate the new or enlarged factories. The amount of each contribution allocable to

cost of training new employees and the cost of providing opening inventory was stipulated as Exhibit 20-T in the stipulation filed with the Tax Court (R. 32-33; R. 119).

If this Court should deny petitioner the use of the transferor's basis for the purpose of computing depreciation and should approve the lower court's action in going behind petitioner's cost as determined by the Tax Court, then petitioner submits that the Court should direct that the contributions be allocated to all of the items for which they were made on the basis of the stipulation filed with the Tax Court.

CONCLUSION

The decision of the Court of Appeals for the Eighth Circuit is wrong and should be reversed.

Respectfully submitted,

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APPENDIX

Statutes and Regulations Applicable During the Taxable Years Ending October 31, 1942, and October 31, 1943.

Internal Revenue Code:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

. . . . . .

(l) [as amended by Sec. 121(c), Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business . . .

. . . . . .

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

. . . . . .

(26 U.S.C. 1946 ed., Sec. 23.)

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the

hands of the donor or the last preceding owner by whom it was not acquired by gift, except that . . .*

* * * * * * *

(8) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined upon subsection (a), adjusted as hereinafter provided.

* * * * * * *

(2) *Substituted basis.*—The term "substituted basis" as used in this subsection means a basis determined under any provision of subsection (a) of

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*The portion of Section 113(a)(2) as set out above was in effect during both taxable years here involved. The remaining portion of the provision which was changed by Section 143(a) of the Revenue Act of 1942 (effective as to taxable years beginning after December 31, 1941, pursuant to Section 101 of that Act), is omitted because it has no bearing on the issues of this case.

this section or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(A) by reference to the basis in the hands of a transferor, donor, or grantor, or

(B) by reference to other property held at any time by the person for whom the basis is to be determined.

Whenever it appears that the basis of property in the hands of the taxpayer is a substituted basis, then the adjustments provided in paragraph (1) of this section shall be made after first making in respect of such substituted basis proper adjustments of a similar nature in respect of the period during which the property was held by the transferor, donor, or grantor, or during which the other property was held by the person for whom the basis is to be determined. A similar rule shall be applied in the case of a series of substituted bases.

(26 U.S.C. 1946 ed., Sec. 113)

Sec. 114. Basis for Depreciation and Depletion.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

. . . . . .

(26 U.S.C. 1946 ed., Sec. 114.)

Sec. 115. Distributions by Corporations.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year

(computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made . . .

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113 . . .

* * * * * * *

(l) [As added by Sec. 501(a), Second Revenue Act of 1940, c. 757, 54 Stat. 974, and amended by Sec. 146(a) of the Revenue Act of 1942, c. 412, 56 Stat. 798] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

(m) [As added by Sec. 501(a), Second Revenue Act of 1940, c. 757, 54 Stat. 974] *Earnings and Profits—Increase in Value Accrued Before March 1, 1913.*—

(1) If any increase or decrease in the earnings or profits for any period beginning after February 28, 1913, with respect to any matter would be different had the adjusted basis of the property involved been determined without regard to its March 1, 1913, value, then, except as provided in paragraph (2), an increase (properly reflecting such difference) shall be

made in that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

(2) If the application of subsection (1) to a sale or other disposition after February 28, 1913, results in a loss which is to be applied in decrease of earnings and profits for any period beginning after February 28, 1913, then, notwithstanding subsection (1) and in lieu of the rule provided in paragraph (1) of this subsection, the amount of such loss so to be applied shall be reduced by the amount, if any, by which the adjusted basis of the property used in determining the loss, exceeds the adjusted basis computed without regard to the value of the property on March 1, 1913, and if such amount so applied in reduction of the decrease exceeds such loss, the excess over such loss shall increase that part of the earnings and profits consisting of increase in value of property accrued before March 1, 1913.

Sec. 712. Excess Profits Credit—Allowance [Added by Sec. 201, 2nd 1940 Act; amended by Sec. 13, Excess Profits Tax Amendments of 1941].

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. (For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.)

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(26 U.S.C. 1946 ed., sec. 712(a))

Sec. 714. Excess Profits Credit—Based on Invested Capital.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is:	The credit shall be:
Not over $5,000,000	8% of the invested capital
Over $5,000,000	$400,000, plus 7% of the excess over $5,000,000.

(as in force during fiscal year ended October 31, 1942)

Sec. 714. Excess Profits Credit—Based on Invested Capital. [as amended by Section 217, Revenue Act of 1942]

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is:	The credit shall be:
Not over $5,000,000	8% of the invested capital.
Over $5,000,000, but not over $10,000,000	$400,000, plus 7% of the excess over $5,000,000.
Over $10,000,000, but not over $200,000,000	$750,000, plus 6% of the excess over $10,000,000.
Over $200,000,000	$12,150,000, plus 5% of the excess over $200,000,000.

(as in force during fiscal year ended October 31, 1943)

Sec. 717. DAILY INVESTED CAPITAL [Added by Section 201, Second Revenue Act of 1940].

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719.

Sec. 718. [As added by Sec. 201, Second Revenue Act of 1940, supra] Equity Invested Capital.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113(b)(2);

* * * * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * * * *

(as in force during fiscal year ended October 31, 1942)

Sec 718. [As added by Sec. 201, Second Revenue Act of 1940, supra] Equity Invested Capital.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798] *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(l) for determining earnings and profits;

. . . . . .

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

. . . . . .

(as in force during fiscal year ended October 31, 1943)

Sec. 719. Borrowed Invested Capital [Added by Section 201, Second Revenue Act of 1940].

(a) *Borrowed Capital.*—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus, . . .

. . . . . .

(b) *Borrowed Invested Capital.*—The borrowed invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

Sec. 728. Meaning of Terms Used [Added by Sec. 201, 2nd 1940 Act].

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

TREASURY REGULATIONS

Treasury Regulations 103, issued under the Internal Revenue Code, as in effect during the taxable year ended October 31, 1942:

Sec. 19.113(a)(8)-1.[23] *Property acquired by a corporation after December 31, 1920.*—. . .

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift the basis thereof shall be determined under section 113(a)(2).

. . . . . .

Sec. 19.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping en-

[23] Section 29.113(a)(8)-1 of Treasury Regulations 111, promulgated under the Internal Revenue Code, as in effect during the taxable year ended October 31, 1943, is identical with Section 19.113(a)(8)-1 of Regulations 103.

tries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a), or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

Treasury Regulations 111, promulgated under the Internal Revenue Code, as in effect during the taxable year ended October 31, 1943:

Sec. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and

which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

Treasury Regulations 109, promulgated under the Internal Revenue Code, as in force during the taxable year ended October 31, 1942:

Sec. 30.718-1.[49] *Determination of daily equity invested capital—Money and property paid in.*— . . .

If the property was acquired after December 31, 1929, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. (See section 113(a)(8).)

Sec. 30.718-2. *Determination of daily equity invested capital—Accumulated earnings and profits*— (a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 30.718-4 as

[49] Section 35.718-1 of Treasury Regulations 112, promulgated under the Internal Revenue Code, as in force during the taxable year ended October 31, 1943, is identical with Section 30.718-1 of Regulations 109.

to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. . . .

Treasury Regulations 112, promulgated under the Internal Revenue Code, as in force during the taxable year ended October 31, 1943:

SEC. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.* (a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. . . .

G.C.M. 16952

(Cumulative Bulletin 1937-1, page 133)

REVENUE ACTS OF 1932 AND 1934

Where a contract was entered into on behalf of a group of citizens with a manufacturing company in order to induce it to locate its plant on certain property, and pursuant thereto such property was conveyed to the company when its pay roll reached a stipulated amount, the grantee did not derive taxable income from such conveyance, nor was the transfer by the grantor subject to the gift tax.

Advice is requested whether the value of property conveyed to the M Company by a group of citizens to induce the company to locate its business on the property constituted taxable income, and whether the transfer of the property was subject to the Federal gift tax.

By virtue of a proceeding held in the chancery court in the city of R, the O Bank, as trustee, took over certain property in trust for the benefit of the citizens of the city of R, who contributed the sum of 6x dollars for the purchase price of the property, factory, machinery, etc. In accordance with the authority conferred upon the O Bank as trustee, it entered into a contract with the M Company and delivered to that company possession of the real estate, factory, machinery, and equipment. In consideration of the surrender of the possession of the property by the trustee, the M Company agreed to pay to the trustee a sum equal to 6 per cent of 6x dollars per annum, or .36x dollars, for a period of 10 years; to pay all State, county, and municipal taxes upon the property; to keep the building, machinery, and equipment insured against loss by fire; and to provide for and pay all items of maintenance and upkeep upon the premises. The M Company also agreed that it would operate the manufacturing plant in the city of R and would not remove the plant therefrom; that the plant would be operated for a period of 10 years; and that if the company ceased operations and the plant was closed for a period of six months, the trustee had the option to terminate the contract and take possession of the premises. The company agreed further that it would operate the plant for all practical purposes as if it were its own, that it would manufacture and market certain articles therein, adequately finance the same, and provide for the purchase of such materials and pay for such labor as was necessary for its operation, the trustee reserving the right to inspect the property and to have such control over the property as a lessor under the laws of the State of S would have over property in the possession of a lessee. In consideration of the covenants and agreements recited in the contract to be performed by the M Company, the trustee agreed that if and when the aggregate annual pay roll of the company in the city of R should equal or exceed the amount of 200x dollars the trustee would deed the property to the M Company in fee simple free and clear of any further charges. When the pay roll of the M Company reached the 200x dollar annual requirement in 1935, the trustee by proper deed transferred the premises in question to that company. The issue presented is the

proper treatment of the transaction for Federal income and gift tax purposes.

In *Edwards* v. *Cuba Railroad Co.* (268 U.S., 628, T.D. 3728, C.B. IV-2, 122), the United States Supreme Court held that subsidy payments made by the Republic of Cuba to a railroad company for the construction and maintenance of a railroad are reimbursements for capital expenditures and are not income, gains, or profits within the meaning of the sixteenth amendment to the Constitution. In several cases the Board of Tax Appeals has followed what it deems to be the principle of the Supreme Court's decisions relative to contributions to corporations generally. In *Appeal of Liberty Light & Power Co.* (4 B.T.A., 155, acquiescence, C.B. VI-1, 4), the Board held that reimbursements for service extensions and connections by utilities did not constitute taxable income. In G.C.M. 1581 (C.B. VI-1, 197), it was held, on authority of the foregoing decisions, that a demonstration plant erected by a foreign corporation at its expense on the taxpayer's premises and transferred to the taxpayer without cost did not constitute taxable income to the taxpayer. In *Frank Holton & Co.* v. *Commissioner* (10 B.T.A., 1317, acquiescence, C.B. VII-2, 18), it was held that the value of property conveyed to a company by business men or a chamber of commerce to induce it to locate its business on the property did not constitute taxable income. In a long line of cases from *Great Northern Railway Co.* v. *Commissioner* (8 B.T.A., 225, acquiescence, C.B. VII-2, 16), to the *Baltimore & Ohio Railroad Co.* v. *Commissioner* (30 B.T.A., 194, acquiescence, C.B. XIII-2, 2), the Board reached a similar conclusion with respect to contributions to railroad companies for construction of side and spur tracks or for other construction work.

This office is of the opinion, in the light of the decisions cited, that the transfer in question did not result in taxable income to the grantee.

The remaining question is whether such transfer is subject to the gift tax imposed by the Revenue Act of 1932, as amended. That Act provides in part as follows:

SEC. 503. *Transfer for less than adequate and full consideration.*

Where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this title, be deemed a gift, and shall be included in computing the amount of gifts made during the calendar year.

Regulations 79 (1936 edition), relating to gift tax, provide in part as follows:

Art. 8. *Transfers for a consideration in money or money's worth.*—Transfers reached by the statute are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration in money or money's worth to the extent that the value of the property transferred by the donor exceeds the value of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. * * *

The facts in the present case justify the conclusion that such transfer was "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)." Therefore, in accordance with article 8 of Regulations 79 (1936 edition), supra, the transfer must "be considered as [having been] made for an adequate and full consideration in money or money's worth." It follows that the transfer is not subject to the Federal gift tax imposed by the Revenue Act of 1932, as amended.

HERMAN OLIPHANT,
General Counsel for the Department of the Treasury.

NEW YORK STOCK CORPORATION LAW

Section 58 of the Stock Corporation Law of the State of New York, as amended in 1938 and 1939 c. 59 of the Consolidated Laws of New York:

> No stock corporation shall declare or pay any dividend which shall impair its capital, nor while its capital is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon reduction of the number or par value of its shares or of its capital, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital.